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1000 CAPITAL ACCOUNTS- ALLOCATION OF PARTNERSHIP INCOME AND LOSS

1010 INTRODUCTION

As a pass-through entity, a partnership computes its income, gain, loss, deduction, and credit at the partnership level and allocates these items among its partners. The partners report their distributive share[1] of these items on their own tax returns. Partners are generally allowed to allocate partnership items of income, gain, loss, deduction, or credit among themselves based on their partnership agreement. However, to be respected for tax purposes, **an allocation of the partnership tax items must be consistent with the underlying economic arrangement among the partners**. If a partner is allocated an item for tax purposes that has no corresponding impact on his economic investment in the partnership, such allocation is disregarded for lack of "substantial economic effect."

To measure the economic value of a partner's investment in a partnership, the partner's capital account is required to be maintained according to § 704 and the regulations promulgated there under. In addition, § 704 regulations also provide special rules regarding allocations attributable to non-recourse liabilities and allocations of appreciated property contributed to or distributed by a partnership. These subjects are discussed in the following sections:

PTM 1000: Allocation of Partnership Income and Loss/Capital Questions (§§ 1000 – 1650)
PTM 2000: Allocations under § 704(c). (§§ 1000 – 2690)
PTM 3000: Allocations attributable to non-recourse liability (§§ 3000 – 3500)

Note: Certain provisions related to oil and gas adjustments are not discussed in these sections (§§ 1000 - 3500).

Observation*: The § 704 regulations are very detailed and complex. They are also logical since they basically allow allocations if the receiving partner bears the burden of such allocation. An understanding of these allocation rules will serve as a foundation for understanding other important areas of partnership tax law.*

1020 CALIFORNIA CONFORMITY

In general, California has adopted IRC § 704 and the federal regulations promulgated thereunder.[California Revenue and Taxation Code § 17851.] Exceptions to the general conformity rules will be discussed in the relevant sections.

1030 ALLOCATION PRINCIPLE

Like most other investments, an investment in a partnership usually results in *tax consequences* (e.g., distributive share of partnership's income, gain, loss, deduction, etc.) and *after-tax economic consequences* that are measured in terms of dollar amounts (e.g., how much the investor gets back from the investment). Though partners are generally allowed to allocate the *tax consequences* among themselves [§ 704(a)], they cannot abuse this allowance by allocating the tax items in a manner different from the allocation of the economic consequences. For example, if a partner is allocated a gain for tax purposes, he must also receive the economic benefit (dollar amount) of such gain. Likewise, if a partner is allocated a partnership tax loss, he must bear an economic risk of loss with regard to such loss. Thus, **the allocation of tax results must follow the allocation of economic results**. [Treas. Reg. § 1.704-1(b)(1)(i)]

Observation*: A partnership agreement usually contains agreements among the partners on how the partnership's taxable income, loss, etc. are allocated to partners (tax allocation), how partnership assets are distributed to partners in both liquidating and non-liquidating distributions (economic benefit allocation), and who is obligated to make additional contributions to satisfy partnership liabilities (economic burden allocation), etc. To guarantee that the allocation of tax items follows the allocation of economic benefit and burden, various complex rules discussed in the following paragraphs are designed by § 704 regulations to make sure that the above allocation principle is applied throughout the full term of a partnership.*

1040 BASIC ALLOCATION RULES

IRC § 704(a) provides that "(A) partner's distributive share of income, gain, loss, deduction or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement." However, the partners' ability to allocate partnership's income or loss is **not** unlimited. To be respected for tax purposes, <u>the allocation must meet one of the following three requirements:</u> [Treas. Reg. § 1.704-1(b)(1)(i)]

- The allocation has *substantial economic effect* (See PTM 1100), or
- The allocation is in accordance with the *partner's interest in the partnership* (See PTM 1600), or
- The allocation is *deemed* to be in accordance with the partner's interest in the partnership under the *special rules* (See PTM 1640).

If an allocation does **not** meet one of those requirements, the partnership's income, loss, deduction, or credit will be reallocated in accordance with the partner's interest in the partnership. [Treas. Reg. § 1.704-1(b)(1)(i)]

If a partnership agreement **does not** provide for the allocation of income, gain, loss, deduction, or credit to a partner, then the partner's distributive share of such income, gain, loss, deduction, or credit will be determined in accordance with such partner's interest in the partnership. [Treas. Reg. § 1.704-1(b)(1)(i)]

1050 EFFECTIVE DATES

- The final regulations under § 704(b) were promulgated in 1991 and are effective *retroactively* to partnership tax years beginning after **December 31, 1975**.

- However, for the taxable years before May 1, 1986, a partnership's allocation will be respected if it has substantial economic effect or is in accordance with the partners' interests in the partnership as those terms have been interpreted under the relevant case law, the legislative history of the 1976 Act, and the old regulations applicable to partnership taxable years beginning before May 1, 1986. [Treas. Reg. § 1.704-1(b)(1)(ii).]

- For partnerships that began operating before May 1, 1986 and continue to operate after April 30, 1986, the partners' capital accounts have to be restated in accordance with the capital account rules. (See PTM 1640)

1060 EFFECTS OF OTHER SECTIONS

The regulations under § 704(b) govern the partnership's allocation of its income, loss, deduction, or credit to its partners only. The tax treatments of each partner's distributive share of such income, loss, deduction, or credit are governed by other sections of the law. For instance, an allocation of loss to a partner may be respected under § 704(b) because it has substantial economic effect but may not be deductible by such partner if, for instance, he does not have the requisite motive for economic gain[2] or disallowed under § 706(d) (changes in partners' interests in partnership during the year) and the related assignment of income principles. The allocated loss may also be limited under § 704(d) (due to a lack of basis), § 465 (at-risk rules), and § 469 (passive activity loss limitations). In other words, the regulations under § 704(b) determine the **validity** of a partnership allocation, not the **tax treatment** or tax consequences of such allocation at the partner's level. [Treas. Reg. § 1.704-1(b)(1)(iii) & (iv).]

1070 COORDINATION BETWEEN IRC § 704(B) AND §704(C)

- Section 704(b) provides the general principle that allocations of tax items (tax results) must follow the allocations of book items (economic results). The regulations under § 704(b) provide rules for allocations of book items. However, when a partner contributes a property to a partnership and the partner's tax basis in the property differs from its fair market value, the law requires that the allocation of the tax items (e.g., built-in gain, loss, depreciation, etc.) with regard to the contributed property must follow a different set of rules under § 704(c) and § 1.704-3.

- The interaction between § 704(b) and § 704(c) is as follows: Though the regulations under § 704(b) do not directly determine the tax allocation provided under § 704(c), a partner's distributive share of the **tax items** may be determined under § 704(c) and §1.704-3 with reference to the partner's share of the **corresponding book items** under § 704(b). Detailed explanations of § 704(c) are provided in PTM 2100.

- For illustration, see PTM 1510, Example 1. [See also Treas. Reg. § 1.704-1(b)(5), Ex. 13(i).]

1080 BOTTOM LINE ALLOCATION

The allocation rules provided under § 704 are applicable to:

- allocations of income, gain, loss, deduction, and credit,
- allocations of specific items of income, gain, loss, deduction, and credit, and
- allocations of partnership net or "bottom line" taxable income or loss. If a share of a partnership's net or "bottom line" income or loss is allocated to a partner, the partner is treated as sharing in each item of income, gain, loss, and deduction that is taken into account in computing such net or "bottom line" taxable income or loss. [Treas. Reg. § 1.704-1(b)(1)(vii).]

Observation: When a partner's distributive share of the partnership (bottom line) income or loss is partially disallowed for lack of substantial economic effect, the allowed portion is treated as consisting of a proportionate share of all items that make up that portion. (See Example in PTM 1150)

1100 SUBSTANTIAL ECONOMIC EFFECT

- A partnership allocation will be respected if it has **substantial economic effect**. The determination of the substantial economic effect involves a two-part analysis made at the end of the partnership taxable year to which the allocation relates. First, the allocation must have **economic effect**. Second, the economic effect of the allocation must be **substantial**. [Treas. Reg. § 1.704-1(b)(2)(i)]
- Meeting one of the above two requirements is not enough for an allocation to be respected. For instance, if an allocation has economic effect but the economic effect is not substantial, such allocation will be disregarded.
- For discussion of the Economic Effect requirements (or Economic Effect test), see PTM 1110.
- For discussion of the Substantiality test, see PTM 1200.

1110 Economic Effect

The fundamental principle: **In order for a tax allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners**. This means that in the event there is an economic benefit or economic burden associated with a tax allocation, the partner to whom the tax allocation is made must also receive such economic benefit or bear such economic burden. [Treas. Reg. § 1.704-1(b)(2)(ii)(a)]

To satisfy the above principle, § 704(b) regulations requires that a partnership agreement must include **all** of the following provisions regarding:

- The maintenance of partners' capital accounts (See PTM 1130, PTM 1300);
- The distribution in liquidation of a partner's interest in the partnership (See PTM 1120);
- The obligation to restore deficit capital account balances (See PTM 1130)

If a partnership agreement does not include all of the above three requirements (referred to as the Economic Effect test), an allocation may still be respected for tax purpose if it passes the Alternate Economic Effect test (See PTM 1140) or the Economic Equivalence test (See 1180). It should be noted that those three tests are to prove the economic effect of an allocation. The Substantiality applies after an allocation passes one of those three economic effect tests.

Example 1: *Cynthia and Phyllis form a partnership to produce a manual for a state agency. The manual is completed during the year and the partnership receives a fee of $10,000. Cynthia and Phyllis agree that the $10,000 fee will be* ***distributed*** *equally between them, thus they* ***share the economic profit equally****. However,* ***for tax purposes, the gain will be specially allocated $7,500 to Cynthia and $2,500 to Phyllis****. The* ***tax allocation (75/25) is <u>not</u> consistent with the underlying economic arrangement (50/50)*** *between Cynthia and Phyllis. Unless the partnership agreement contains other provisions that meet the allocation requirements (See* PTM 1040*), the tax allocation has no economic effect and has to be reallocated to the partners based on their economic sharing ratio (50/50).*

Example 2*: Al and Kay form a partnership. Al and Kay contribute $1,000 and $99,000 in cash, respectively. Due to Al's expertise in management and his daily participation in the partnership's business, the partnership agreement provides that Al will be allocated 20% of the partnership taxable income and 1% of the partnership loss. Thus, although Al owns only 1% in partnership capital, his profit sharing ratio is 20%. This tax allocation between Al and Kay is respected as long as the distribution of economic benefits between the two is also in the same ratio (i.e., 20% to Al and 80% to Kay).*

Observation*: There has been some misunderstanding that a "special allocation" similar to the one described in Example 2 is an abuse of the tax law. However, the law generally respects such allocations provided the tax allocations correspond to the economic arrangements (See Examples in* PTM 1140*).*

1120 Economic Effect Requirements

An allocation of income, gain, loss, deduction, and credit to a partner will have economic effect if, and only if, <u>throughout the full term of the partnership</u>, **the partnership agreement (either oral or written,** see PTM 1170**) includes the following three requirements** [Treas. Reg. § 1.704-1(b)(2)(ii)(b)] (together: the Economic Effect requirements, sometimes called the Mechanical tests):

1. *The Maintenance Requirement*: The partners' capital accounts must be determined and maintained in accordance with the rules provided in § 1.704-1(b)(2)(iv) (See PTM 1300),
2. *The Distribution Requirement*: Upon liquidation of the partnership (or any partner's interest in the partnership), **liquidating distributions are required to be made in accordance with the positive capital account balances** of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs. The liquidating distribution has to be made by the end of such taxable year (or, if later, within 90 days after the date of such liquidation) (See PTM 1160 for definition of liquidation).
3. *The Deficit Restoration Requirement*: If a partner has a deficit in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all the capital account adjustments during the liquidating year, he is **unconditionally obligated to restore the amount of such deficit balance** to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation). The amount will be paid to the creditors of the partnership or distributed to other partners in accordance with their positive capital account balances. For the purpose of this paragraph, the taxable year of a partnership is determined without regard to § 706(c)(2)(A), which provides that the partnership's taxable year is closed with respect to a partner who sells or exchanges his entire interest in the partnership. (If a partnership agreement fails to includes this agreement, See PTM 1130 for other requirements)

The above three requirements must be in effect throughout the full term of the partnership. If the partnership agreement is modified after it originally included the above three requirements, see PTM 1650.

Notes:

Unless specified otherwise, the term "capital account(s)" used in this chapter implies that the capital accounts are determined and maintained according to §704(b). This type of capital account is also referred to as "book" or § 704(b) capital account as distinct from tax-basis capital accounts, § 704(c) capital accounts, or financial accounting capital accounts. (See PTM 1300.)

If the partnership does not meet the Economic Effect test (i.e., containing the above three requirements), see the Alternate Economic Effect test discussed in PTM 1140 **and the Economic Equivalence Test discussed in** PTM 1180**.**

Example 1: *John and Janet form a general partnership. Each makes a cash contribution of $50,000, which is used by the partnership to purchase a piece of land for $100,000. Before the end of the taxable year, the partnership sells the land for $150,000 and recognizes a gain of $50,000. According to the partnership agreement, John and Janet will share equally in partnership taxable losses and cash flow. However, all partnership gains will be allocated 80% to John and 20% to Janet. The partnership agreement also provides that the partners' capital accounts will be determined and maintained in accordance with § 704(b) regulations, but that upon liquidation of the partnership, distribution will be made* ***equally*** *between the partners (regardless of the partners' capital account balances) and* ***no partner is required to restore his deficit capital account****. Assuming at the end of the year, the partnership distributes the sales proceeds ($150,000) equally to the partners and liquidates. The tax allocation and economic allocation will be as follows:*

Capital Accounts	***John***	***Janet***	***Total***
Beginning of the year	*$50,000*	*$50,000*	*$100,000*
Allocation of Taxable Gain	*40,000*	*10,000*	*50,000*
Less: Economic Distribution	*(75,000)*	*(75,000)*	*(150,000)*
Balance at Liquidation	*$15,000*	*($15,000)*	*$0*

As can easily be seen, John is allocated 80% of the gain for tax purposes ($40,000) but receives a distribution of only 50% of the gain, $25,000, while Janet is allocated 20% of the taxable gain, $10,000, but receives a distribution of 50% of the economic gain, $25,000. The special allocation of taxable gain results in positive capital account for John and negative capital account for Janet after distribution. Since the liquidating distribution is not based on the partners' positive capital accounts and the partner with negative capital account balance is not required to make contribution to the partnership to pay for the partner with positive capital account, the allocation of the taxable gain between John and Janet has no economic effect and therefore has to be reallocated in accordance with their partnership interest, which is 50/50.

Observation*: It is assumed in this example that the partnership agreement does not meet the Alternate Economic Effect test (See* PTM 1140*) and the Economic Equivalent test (See* PTM 1180*)*

Example 2*: Assume the same facts as Example 1 except that the partnership agreement requires that liquidating distributions have to be made in accordance with the partners' positive capital accounts. As a result, John will receive $90,000 and Janet will receive $60,000. Thus, the economic gain of $50,000 is distributed in the ratio of 80/20 to John and Janet, respectively. The tax allocation is now valid since it is consistent with the economic arrangement between the partners.*

Capital Accounts	***John***	***Janet***	***Total***
Beginning of the year	*$50,000*	*$50,000*	*$100,000*
Allocation of Taxable Gain	*40,000*	*10,000*	*50,000*
Balance Before Distribution	*90,000*	*60,000*	*150,000*
Less: Economic Distribution	*(90,000)*	*(60,000)*	*(150,000)*
Balance at Liquidation	*$0*	*$0*	*$0*

Observation: *In the above example, the partnership agreement does not require the partners to restore the deficit capital account balances but the allocation is still valid since the partners' capital accounts do not become negative as a result of the allocation. Had this been an allocation of partnership loss and the allocated amount of the loss is in excess of the partners' capital accounts, the allocation may not be respected with regard to the excess loss.*

1130 Obligation to Restore Deficit

In order for an allocation to have economic effect, a partnership agreement must contain the Deficit Restoration Requirement, which requires partners to restore their deficit capital account balances (See PTM 1120). However, if the partnership agreement does not expressly require the partners to restore their deficit capital accounts, **an allocation may still be treated as having economic effect** if: [Treas. Reg. § 1.704-1(b)(2)(ii)(c).]

- The partnership complies with the alternate economic test (See PTM 1140), or
- The partner contributes a personal promissory note to the partnership (provided that the note meets the requirements specified below), or
- The partner is unconditionally obligated to make subsequent contribution to the partnership (other than pursuant to a promissory note stated above). The amount of any unconditional obligation may be imposed by the partnership agreement or by State or local law. (See Examples and Observation below)

A contribution of a note or an obligation to make subsequent contribution must meet the following requirements:

- If the partner contributes a note to the partnership, or is obligated to make subsequent contribution to the partnership, such note or obligation is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated or within 90 days after the date of such liquidation.
- If a partner (who is also the maker of the note) contributes a promissory note to the partnership, the following requirements have to be satisfied:

  - The note has to be contributed within the time required (explained above),
  - The note is negotiable, and
  - The partnership has to retain such note and the partner has to contribute to the partnership the excess, if any, of the outstanding principal of such note over its fair market value at the time of liquidation.

However, it should be noted that if such obligation is not legally enforceable or the facts and circumstances otherwise indicate a plan to circumvent such obligation, the partner is not considered to have satisfied the requirement to restore his deficit capital account. [Treas. Reg. § 1.704-1(b)(2)(ii)(c).]

Example 1*: Upon the formation of the partnership, Paul contributes to the partnership his negotiable promissory note with a $10,000 principal balance. The note unconditionally obligates Paul to pay $10,000 to the partnership (1) at the end of the partnership's fifth taxable year or (2) at the end of the year Paul's partnership interest is liquidated. Paul is considered obligated to restore up to $10,000 of his deficit capital account balance to the partnership. (Thus, if the partnership allocates losses that cause a deficit (up to $10,000) in Paul's capital account, such an allocation has substantial economic effect.)*

Example 2*: Same facts as in Example 1 except Paul is only required to pay at the end of the partnership's fifth taxable year regardless of when his partnership interest is liquidated. In this situation, his deficit capital account restoration obligation is still considered satisfied provided that the partnership retains the note and Paul agrees to contribute to the partnership any excess of the outstanding balance of the note over its fair market value*. [*See Treas. Reg. § 1.704-1(b)(5) Example (1)(ix).] (e.g., if the partnership disposes of Paul's personal note for $9,000, Paul has to reimburse the partnership $1,000.)*

Example 3*: Same facts as in Example1 except Paul's obligation to restore his negative capital account is not evidenced by a promissory note. Instead, the partnership agreements imposes upon Paul the obligation to make an additional contribution of $10,000 at the earlier of (1) the end of the partnership fifth taxable* *year or (2) the end of the partnership taxable year in which Paul's interest in the partnership is liquidated. Paul is considered to have satisfied his deficit capital account restoration obligation up to $10,000. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(x).]*

***Observation**: It should be noted that the obligation to make a <u>subsequent contribution</u> is different from the obligation to <u>restore the deficit capital account</u>. When a partner is obligated to make a subsequent contribution, the contribution amount is usually predetermined under the partnership agreement. On the contrary, the obligation to restore the deficit capital account generally requires the partner to contribute the negative balance in his or her capital account. Some limited partnership agreements may not contain the deficit capital account restoration requirement because they are designed to limit the potential economic exposure of limited partners through unlimited additional capital contributions under the deficit capital account restoration requirement. In such situations, the regulations provide some relief to these limited partners through the alternate economic effect test and other limited restoration obligations. Thus, if the partnership agreement does not provide for a deficit restoration obligation, allocations of losses may still be respected if they meet the alternative requirements. Again, in examining these requirements, the auditor needs to be aware of potential planning to circumvent or avoid these obligations. For instance, if a promissory note is not legally enforceable (e.g., the partnership cannot enforce a payment under the jurisdiction of the maker's state or country), such note may not be respected.*

*Another important requirement is that the obligation to restore the negative capital account must be **expressly** provided by the partnership agreement and cannot be relied upon similar requirements under the state or local law. See further explanations in* PTM 2920

1140 Alternate Test for Economic Effect

If the requirement regarding the restoration of the deficit capital account balance is not provided for in the partnership agreement, or if a partner is required to restore only a limited dollar amount of such deficit balance, **an allocation may still be treated as having economic effect if it meets all of the following requirements under the Alternate Economic Effect Test:** [Treas. Reg. § 1.704-1(b)(2)(ii)(d)]

1. The partnership agreement contains a "**qualified income offset**" statement. A partnership agreement contains a "qualified income offset" if, and only if, it provides that **a partner who unexpectedly receives an**

adjustment, allocation, or distribution described in item 3(a), 3(b), or 3(c) below, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.

2. The allocation does not cause or increase a deficit balance in such partner's capital account as of the end of the partnership taxable year to which such allocation relates, and
3. Such partner's capital account must also be reduced by the following "special adjustments": [Treas. Reg. § 1.704-1(b)(2)(ii)(d)] (For illustration of this requirement, see Example 4 below.)

   - Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under treasury regulation §1.704(b)(2)(iv)(k) (relates to depletion allowances for oil and gas properties of the partnership),
   - Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to § 704(e)(2) (relates to family partnership rules), § 706(d) (relates to the determination of a partner's distributive share when the partner's interest changes), § 1.751-1(b)(2)(ii) (relates to a distribution of § 751 property to which another partner has a special basis adjustment), and
   - Distributions to the partner that are in excess of the increases to such partner's capital account during or prior to the partnership's taxable years in which such distributions reasonably are expected to be made.

Notes regarding the last bulleted item: The increases mentioned above do not include the increases pursuant to a minimum gain chargeback (See PTM 3340) under § 1.704-1(b)(4)(iv)(e) or under § 1.704-2(f). However, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to a distribution of non-recourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain. For purposes of determining the amount of expected distributions and expected capital account increases described above, the rule set out under the Transitory Allocations (See PTM 1220) concerning the presumed value of partnership property shall apply.

Notes: If the partnership does not meet the requirements under the Economic Effect test or the Alternate Economic Effect test, see the Economic Equivalence test discussed in PTM 1180.

***Example 1**: Steve and Jerry form a general partnership. Each contributes $50,000, which is used by the partnership to buy depreciable personal property for $100,000. The partnership agreement provides that Steve and Jerry will have an equal share of partnership taxable income and loss (computed without regard to cost recovery deductions (i.e., depreciation deductions)) and that **all cost recovery deductions will be allocated to Steve**. The agreement further provides that the partners' capital accounts will be maintained in accordance with § 1.704-1(b)(2)(iv), and that distributions in liquidation will be made in accordance with the partners' positive capital account balances throughout the term of the partnership. (Note that **there is no requirement that a partner with a negative capital account has to restore his deficit balance**.) The partnership agreement contains a <u>qualified income offset</u> statement and as of the end of each partnership taxable year, the items described in (a), (b), and (c) above (See* PTM 1140*, item (3)) are not reasonably expected to cause or increase a deficit balance in Steve's capital account.*

In the partnership's first taxable year, it recognizes operating income equal to its operating expenses and has an additional $30,000 cost recovery deduction which is allocated entirely to Steve.

<u>Capital Accounts</u>	***<u>Steve</u>***	***<u>Jerry</u>***
Beginning of the 1st year	*$50,000*	*$50,000*
Less: Cost Recovery Deduction	*<u>(30,000)</u>*	*<u>0</u>*
End of the 1st year	*$20,000*	*$50,000*

*Under the **alternate economic effect test**, the allocation of the depreciation deduction to Steve has economic effect because (1) the partnership agreement has a qualified income offset, (2) none of the items described in (a), (b), and (c) above are expected at the end of the first year, and (3) the allocation of the depreciation does not cause a deficit in Steve's capital account. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(iii).]*

***Observation**: In the above example, the allocation of depreciation deductions to Steve would have failed under the economic effect because the partnership agreement does not require a capital account deficit restoration. However, **under the alternate economic test, the allocation has economic effect** as explained above.*

***Example 2**: Assume the same facts as in Example 1 and that in year 2, the partnership recognizes operating income equal to its operating expenses and has a $30,000 cost recovery deduction which is allocated entirely to Steve according to the partnership agreement.*

Capital Accounts	***Steve***	***Jerry***
Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Cost Recovery Deduction	*(30,000)*	*0*
End of the 2nd year	*($10,000)*	*$50,000*

The allocation of the $30,000 depreciation deduction to Steve causes a $10,000 deficit in his capital account. Therefore, the allocation ***satisfies the alternate economic test only to the extent of $20,000*** *and only this portion ($20,000) of the allocation ($30,000) has economic effect. The remaining $10,000 must be reallocated in accordance with the partners' interest in the partnership (which is 50/50). However, under the general principle (See* PTM 1010*) that the partner who is allocated a partnership loss must bear the economic burden with regard to the loss, it is necessary to determine who actually bears the economic risk of loss with regard to this $10,000 loss. If the partnership sells the property immediately at the end of the partnership's second taxable year for $40,000 (its adjusted tax basis: total cost of $100,000 less depreciation of $60,000), the entire $40,000 proceeds will be allocated to Jerry pursuant to the partnership agreement (liquidation distribution in accordance to partners' positive capital accounts). Since Jerry's total investment is $50,000 and he receives only $40,000 in the hypothetical liquidation distribution, he bears the economic risk of loss of $10,000. Thus, the remaining $10,000 of the $30,000 cost recovery deduction has to be reallocated to Jerry because he bears the economic burden corresponding to such amount. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(iv).]*

For reallocation method, see also PTM 1630

Example 3*: Assume the same facts as in Example 2 except that the cost recovery deduction for the second year is $20,000 instead of $30,000. The allocation of the $20,000 cost recovery deduction to Steve has economic effect under the alternate economic effect test as discussed in Example 1. Assume further that the partnership sells the property for $20,000 immediately following the end of the partnership's second taxable year and the partnership is liquidated. The sale results in $30,000 loss (the partnership's adjusted basis in the property is $50,000 (total cost $100,000 less $50,000 accumulated depreciation taken in year 1 and 2)). Under the partnership agreement, Steve and Jerry share equally in partnership income and loss. Thus, the $30,000 loss on the sale of the property is allocated equally to Steve and Jerry. However, this allocation has* ***no*** *economic effect as shown below:*

Capital Accounts	***Steve***	***Jerry***

Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Cost Recovery Deduction	*(20,000)*	*0*
End of the 2nd year	*0*	*$50,000*
Less: Loss on sale	*(15,000)*	*(15,000)*
Cap. acct. before Liquidation	*(15,000)*	*$35,000*
Distribution of sales proceeds	*0*	*(20,000)*
Ending Balance	*($15,000)*	*$15,000*

Under the partnership agreement, liquidating distributions are made in accordance with the partners' positive capital accounts. Thus, the sales proceeds ($20,000) is distributed to Jerry. After the distribution, he still has a positive capital account of $15,000 while Steve's capital account is negative. Thus, the allocation of the $30,000 taxable loss on the sale of the property to Steve according to the partnership agreement (50/50) does not have economic effect because Jerry is the one who bears the economic loss (i.e., his capital account shows a positive balance of $15,000 at liquidation). As a result, the $15,000 taxable loss allocated to Steve based on the partnership agreement has to be reallocated to Jerry. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(v).] On their returns filed for year 2, Steve will report $20,000 loss and Jerry will report $30,000 loss from the partnership.

Capital Accounts	***Steve***	***Jerry***
Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Cost Recovery Deduction	*(20,000)*	*0*
End of the 2nd year	*0*	*$50,000*
Less: Loss on sale	*0*	*(30,000)*
Cap. acct. before Liquidation	*0*	*$20,000*
Distribution of sales proceeds	*0*	*(20,000)*
Ending Balance	*$0*	*$0*

***Observation**: In Examples 1 and 3, from an economic standpoint, Steve's investment of $50,000 results in taxable loss of $30,000 and $20,000 in year 1 and 2, respectively. Jerry's $50,000 investment results in $0 loss in year 1, $30,000 loss in year 2, plus a distribution of $20,000 from the partnership.*

The special allocation of cost recovery deductions to Steve in year 1 and 2 has substantial economic effect under the alternate economic test. However, the $30,000 taxable loss from the sales of the property has to be allocated entirely to Jerry because he bears the economic loss (in spite of their agreement to share equally in partnership loss).

***Examples 4**: Assume the same facts as in Example 2 except that the cost recovery deduction in year 2 is $20,000 and that at the end of year two, it is reasonably expected that during its **third** taxable year the partnership will (1) have operating income equal to its operating expenses and will have no cost recovery deductions and (2) borrow $10,000 (recourse) and distribute the amount equally to Steve and Jerry and (3) thereafter sell the property, repay the $10,000 loan, and liquidate. In determining if the special allocation of the $20,000 cost recovery deduction to Steve in year 2 meets the alternate test, the fair market value of the property is presumed to be equal to its adjusted tax basis, which is $50,000 (total cost of $100,000 less accumulated depreciation of $50,000 taken in year 1 and 2). Thus, there will be no gain on the sale of the property and there can be no reasonable expectation that there will be any increases to Steve's capital account in the third taxable year that will offset the expected $5,000 distribution to Steve. Therefore, the expected distribution of the loan proceeds in year three must be taken into account in determining to what extent the alternate economic test is satisfied.*

Capital Accounts	***Steve***	***Jerry***
Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Expected Distribution	*(5,000)*	*(5,000)*
Less: Year 2 cost recovery deduction	*(20,000)*	*0*
End of the 2nd year	*($5,000)*	*$45,000*

Upon the sale of the property, the $50,000 sales proceeds will be used to pay off the $10,000 liability and the remaining $40,000 will be distributed to Jerry (in accordance with the partnership agreement.)

Under these circumstances the allocation of $20,000 cost recovery deduction to Steve in year 2 satisfies the alternative economic effect test only to the extent of $15,000. The remaining $5,000 of the cost recovery deduction will be allocated to Jerry.

The results in this example would be the same as above even if the partnership agreement provides that the gain on the sale of the property would be allocated to Steve to the extent of the cost recovery allocated to him previously and that at the end of the second year the partners are confident that the gain on the sale of the property in year three will be sufficient to offset the expected $5,000 distribution to Steve. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(vi).]

Observation**: This example illustrates one of the "special adjustments" to capital accounts mentioned earlier in this paragraph. The distribution of the $5,000 loan* *proceeds expected to occur in year 3 is taken into account in determining Steve's capital account in year 2 and therefore limits the amount of the cost recovery deduction allocated to Steve in year 2. Note that under the alternate economic test, an allocation* ***cannot *create a deficit balance in a partner's capital account. In this example, though the allocation of $20,000 cost recovery deduction in year 2 does not cause Steve's capital account to be negative, the expected distribution in year 3 will cause Steve's capital account to be negative. Therefore, the allocated cost recovery deduction to Steve in year 2 must be reduced to the extent of the potential deficit amount. (A partner's capital account is reduced by distributions from the partnership to such partner. See* PTM 1400*). The effect of this rule is to prevent the situation where a partner's capital account is increased before year-end to allow him to be allocated losses and immediately reduced the following year through distribution.*

Example 5*: Assuming the same facts as in Examples 2 except that the partnership agreement provides that any partner with a deficit capital account following the liquidation of his interest must restore the deficit to the partnership. Assume further that the partnership allocates its cost recovery deduction of $30,000 in year 2 to Steve and sells the property for $35,000 at the end of year 2 and liquidates. The sale of the property results in a loss of $5,000 (total cost of $100,000 less accumulated depreciation of $60,000 to give the adjusted basis of $40,000). The sales proceeds of $35,000 is distributed to Jerry pursuant to the partnership agreement.*

Capital Accounts	***Steve***	***Jerry***
Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Cost Recovery Deduction	*(30,000)*	*0*
Less: Loss on sale of the property		*(5000)*
Less: Distribution of sales proceeds		*(35,000)*
End of the 2nd year	*($10,000)*	*$10,000*

Since the partnership agreement requires any partner with a deficit capital account to restore it, Steve would be obligated to contribute $10,000 (the deficit balance in his capital account) to the partnership, and that $10,000 will be distributed to Jerry. Thus, the allocation of $30,000 cost recovery deduction to Steve in year two has economic effect because the partnership agreement contains all three requirements under the economic effect test. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(vii).] (See PTM 1140*).*

Observation*: This example shows that the obligation to restore a deficit capital account is essential in preventing a partner from being allocated losses that he does not bear economically. Assuming the law does not require Steve to restore* *his deficit capital account nor prevent him from being allocated losses that have no economic effect, Steve would have a total tax loss of $60,000 in two years while his economic outlay is only $50,000.*

***Example 6**: Assume the same facts as in Example 5 except that Steve is required to restore the deficit balance in his capital account up to a maximum of $4,000. Thus, the allocation of the $30,000 cost recovery deduction to Steve has economic effect under the alternate test up to $24,000. The remaining $6,000 cost recovery deduction has to be allocated to Jerry. Also, Steve has to contribute $4,000 to the partnership at the end of year two (when the partnership liquidates) and the partnership distributes that $4,000 to Jerry. [See Treas. Reg. § 1.704-1(b)(5) Example (1)(viii).]*

1150 Partial Economic Effect

If only a portion of an allocation made to a partner has economic effect, both the portion that has economic effect and the portion that is reallocated (due to the lack of economic effect) shall consist of a proportionate share of all items that made up the allocation to such partner for such year. [Treas. Reg. § 1.704-1(b)(2)(ii)(e)]

***Example**: Kim owns a 50% limited interest in a partnership that owns a rental property. The partnership agreement provides that Kim is not obligated to restore her deficit capital account upon liquidation. Her capital account balance at the beginning of the year is $500. During the year, the partnership generates the following items of income and expenses:*

	Partnership	Kim
Rent	*$10,000*	*$1,000*
Operating expenses	*(2,000)*	*(200)*
Interest expenses	*(6,000)*	*(600)*
Deprec. Ded.	*(7,000)*	*(700)*
Net Rental loss	*($5,000)*	*($500)*

Kim's share of the net rental loss is $2,500. However, only $500 of the loss allocated to her has substantial economic effect. The remaining loss of $2,000 is allocated to the other partners. The $500 loss allocated to Kim is treated as consisting of a proportionate share (10%) of all items that made up the $500 loss as shown above. [See Treas. Reg. § 1.704-1(b)(5) Example (15)(ii).]

1160 Definition of Liquidation

Liquidation of a partner's interest in the partnership: A partner's interest in the partnership is considered liquidated upon the earlier of: [Treas. Reg. § 1.704-1(b)(2)(ii)(g)]

- the date upon which there is a liquidation of the partnership, or
- the date upon which there is a liquidation of the partner's interest in the partnership under treas. reg. § 1. 761-1(d). Section 1.761-1(d) provides that the term "liquidation of a partner's interest" means a termination of a partner's entire interest in a partnership by means of a distribution or a series of distributions, to the partner by the partnership. Where a partner's interest is to be liquidated by a series of distributions (made in one year or more than one year), the interest will not be considered as terminated until the final distribution has been made.

Liquidation of a partnership: The liquidation of a partnership occurs upon the earlier of: [Treas. Reg. § 1.704-1(b)(2)(ii)(g)]

- the date upon which the partnership is terminated under § 708(b)(1), or
- the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners.

IRC § 708(b)(1) provides that a partnership shall be considered terminated if (A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership or (B) within a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

Potential Abuses: If the liquidation of a partner's interest in a partnership is delayed after the partnership's primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity), such a delay will be treated as incurred for a principal purpose of deferring any distribution to the partners with positive capital accounts or deferring a partner's obligation to restore a deficit capital account. [Treas. Reg. § 1.704-1(b)(2)(ii)(g)]

1170 Definition of Partnership Agreement

A partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether **oral** or **written**, and whether or not embodied in a document referred to by the partners as the partnership agreement.

As a result, in determining whether distributions are required to be made in accordance with the partners' positive capital accounts, or the extent to which a partner is required to restore the deficit capital account balance, it is necessary to consider all arrangements among the partners or between the partners and the partnership, direct or indirect, including puts, options, buy-sell agreements, and other stop-loss arrangements as parts of the partnership agreement.

An agreement with a partner or a partnership also includes an agreement with a related person to such partner or partnership.

In addition, the partnership agreement includes provisions of Federal, State, or local law that govern the affairs of the partnership or are considered under such law to be part of the partnership agreement. Treasury regulation § 1.761-1(c) provides that if the partnership agreement, or any modification thereof, is silent with regard to any matter, the provisions of local law shall be considered a part of the agreement. [Treas. Reg. § 1.704-1(b)(2)(ii)(h)]

1180 Economic Effect Equivalence

The economic effect rules (See PTM 1120) require that (1) partners' capital accounts be maintained in accordance with the § 704(b) regulations, (2) liquidation distributions be made in accordance with the partners' positive capital account balances, and (3) partners with deficit capital accounts have to restore the deficit balances. However, if a partnership agreement does not contain any of these requirements, allocations made to partners nevertheless are deemed to have economic effect if a liquidation of the partnership at the end of a taxable year (or of any future year) would produce the same economic results as under the three requirements above. [Treas. Reg. § 1.704-1(b)(2)(i)]

***Example 1**: Susan and Lori contribute $9,000 and $1,000, respectively, to form a general partnership. The partnership agreement provides that all income, gain, loss, and deductions will be allocated **equally** between the partners, that the partners' capital accounts will be determined and maintained in accordance with the regulations, but that all partnership distributions, regardless of capital account balances, will be made 90% to Susan and 10% to Lori. The partners are not required to restore their deficit capital account balances at liquidation. Thus, the* *tax allocations (50/50) in the partnership agreement do not have economic effect. If contributions to partnership are made in the 90/10 ratio, and the partnership agreement provides that all partnership's economic profits and losses are to be shared in the 90/10 ratio (i.e., liquidating distributions to be made in the 90/10 ratio), the allocations of all partnership income, loss, gain, and deductions must also be in the same ratio of 90/10. Such allocations are respected under the economic effect equivalence test. [See Treas. Reg. § 1.704-1(b)(5) Example (4)(i).]*

Example 2: *Same facts as in Example 1 except that the partnership does not maintain capital accounts and the partnership agreement provides that all income, gain, loss, deductions will be allocated 90% to Susan and 10% to Lori. Susan and Lori are ultimately liable (under a State law right of contribution) for 90% and 10%, respectively, of any debts of a partnership. Although the allocations do not satisfy the capital account maintenance requirement under § 704(b)(2)(ii)(b), the allocations have economic effect under the economic effect equivalence test as discussed above. To illustrate, assume further that during the year, the partnership borrows $20,000 from a bank on a recourse basis. Both Susan and Lori, as general partners, are personally liable for repayment of the loan. The partnership uses all its $30,000 cash to invest in stock of a corporation which becomes totally worthless at the end of the year. Susan and Lori make additional contribution of $18,000 and $2,000 to the partnership to pay off the $20,000 loan to the bank.*

Capital Accounts	***Susan***	***Lori***
Beginning of the year	*$ 9,000*	*$1,000*
Less: Stock Loss	*(27,000)*	*(3,000)*
Additional Contribution	*$18,000*	*$2,000*
Ending Capital	*0*	*0*

Thus, although the partnership agreement does not meet the requirements under the economic effect test, the allocation of the tax loss to Susan and Lori has the same economic effect as if all three requirements under the economic effect test are satisfied and the allocation is deemed to have economic effect. [See Treas. Reg. § 1.704-1(b)(5) Example (4)(ii).] (Or, respected under the economic effect equivalence test.)

Observation*: The situation in Example 2 above probably reflects a large number of partnerships the auditor may encounter. Many of these partnership agreements may not contain all or some of the general requirements under the substantial economic effect. However, an absence of these requirements has no material bearing on the allocations of partnership taxable income or loss because* *the allocations are generally based on the partners' capital interests in the partnership. Note that the principal purpose of the substantial economic effect tests is to prevent abuses regarding special allocations of certain partnership items of income or deduction. If the allocations are not "special", then whether or not the requirements under the economic effect are contained in the partnership agreement does not make any difference. The auditor should refer to* PTM 2910 *for scoping suggestions.*

1200 SUBSTANTIALITY

In order for an allocation to be respected, it must have **economic effect** (See PTM 1120) and the economic effect must be **substantial**. If an allocation has economic effect but the economic effect is not substantial, such allocation will be disregarded.

The economic effect of an allocation is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent from the tax consequences. [Treas. Reg. § 1.704-1(b)(2)(iii)]

The economic effect of an allocation is **not** substantial if at the time the allocation becomes part of the partnership agreement:

- the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation was not contained in the partnership agreement, and
- there is a strong likelihood that the after-tax economic consequences of no partner will, in present value term, be substantially diminished compared to such consequences if the allocation was not contained in the partnership agreement. [Treas. Reg. § 1.704-1(b)(2)(iii)]

For illustration, see Examples in PTM 1210 and PTM 1220.

There are two types of allocations that are **not** substantial:

- The "shifting of tax consequences" which relates to shifts that occur within a single tax year (See PTM 1210), and
- The "transitory tax consequences" which relates to shifts that occur over a number of tax years (See PTM 1220).

1210 Shifting of Tax Consequences

The economic effect of an allocation in a partnership taxable year is **not** substantial if at the time the allocation becomes part of the partnership agreement, there is a strong likelihood that:

- (First condition) the net increases and decreases in the partners' capital accounts for such taxable year will not differ substantially from the net increases or decreases in such partners' capital account if the allocations were not contained in the partnership agreement, and
- (Second condition) the total tax liability of the partners for the taxable years in which the allocations are taken into account will be **less** than if the allocations were not contained in the partnership agreement. It is necessary to take into account the tax consequences that result from the interaction of the allocations with partner tax attributes that are unrelated to the partnership.

Example: *A and B are* ***equa****l partners in a partnership. The partnership agreement contains all requirements regarding the maintenance of the capital accounts in accordance with the § 704(b) rules, the liquidation distribution according to partners' positive capital account and the deficit capital account restoration obligation. During the year, the partnership generates passive income (from rental real estate) of $5,000 and capital gain of $5,000. A has $7,000 in passive losses from investments in other rental real estate unrelated to the partnership. B has $11,000 in capital loss carryovers from previous years. A and B agree that the entire passive income will be allocated to A and the entire capital gain will be allocated to B. Assume both partners are in the 28% tax bracket. The after-tax economic consequences under the special allocation will be as follows:*

	A	***B***	***Total***
Passive Income	*$5,000*	*0*	*$5,000*
Capital Gain	*0*	*$5,000*	*$5,000*
Less: Taxes on income(*)	*0*	*0*	*0*
Net Cash after tax	*$5,000*	*$5,000*	*$10,000*

(*) The taxes on income are zero since A offsets the passive income of $5,000 against passive losses from other investments and B offset the $5,000 capital gain against the capital loss carryover.

The after-tax economic consequences ***without*** *special allocation will be as follows:*

	A	***B***	***Total***
Passive Income	*$2,500*	*$2,500*	*$5,000*
Capital Gain	*2,500*	*$2,500*	*$5,000*
Less: Taxes on income (*)	*(700)*	*(700)*	*(1,400)*
Net Cash after tax	*$4,300*	*$4,300*	*$8,600*

(*) A's passive income of $2,500 will be offset by the passive losses from other investments. However, A will have to pay $700 in taxes on the capital gain ($2,500 x 28%). B's capital gain of $2,500 will be offset by the capital loss carryover but B will have to pay $700 taxes on the $2,500 passive income. (For simplicity, ignoring other minor allowances for deductions regarding capital losses or passive losses.)

*Based on the above analysis of the after-tax consequences, the allocation meets the first condition that the net increases in the partners' capital accounts do not differ substantially (i.e., with or without the special allocation, each partner's capital account are increased by the same $5,000 in income) and the second condition that the total tax liability under the special allocation is **less** than the tax liability if there is no special allocation (i.e., both partners are better off after taxes.) Therefore**, it will be presumed that at the time the allocation became part of such partnership agreement, there was a strong likelihood that these results would occur. As a result, the special allocation is insubstantial** and the passive income and the capital gain have to be allocated equally between A and B.*

The above presumption may be overcome by a showing of facts and circumstances that prove otherwise. [Treas. Reg. § 1.704-1(b)(2)(iii)(b)(2)] For instance, assume the same facts as above except that at the time when A and B entered into the agreement to specially allocate the passive income and the capital gain, they had no expectation of deriving such individual tax benefits from such allocation (i.e., A did not know he would have passive losses from other investments and B did not know he would have capital loss carryover), then the allocation may be considered substantial.

***Observation**: The above example illustrates the purpose of the substantiality test: it is designed to prevent special allocations based on the **character** of the partnership income or deductions but have no effect on the dollar value of the partner's interest. The test is based on the after-tax economic consequences of the allocation. To be substantial, if the after-tax economic consequence of one partner is **enhanced** due to the allocation, the after-tax economic consequences of other partners must be **diminished** due to such allocation. In other words, an allocation that causes after-tax benefit to a partner must also cause a significant after-tax cost to any other partner. In the above example, the allocation causes after-tax benefits to both A and B and does **not** diminish any partner's after-tax consequences, thus the allocation is **not** substantial.*

1220 Transitory Allocations

If a partnership agreement provides for the possibility that one or more allocations (the "original allocations") will be largely offset by one or more allocations (the "offsetting allocations") within 5 years, and at the time the allocations become part of the partnership agreement, there is a strong likelihood that:

- the net increases or decreases in the partners' capital account will **not** differ substantially with or without the original and the offsetting allocations, and
- the total tax liability of a partner will be **less** than if the allocations were not contained in the partnership agreement.

If the above two conditions occur, **there is a presumption that the allocation is not substantial**. The presumption can be overcome by a showing of facts and circumstances that prove otherwise. [Treas. Reg. § 1.704-1(b)(2)(iii)(c)]

The Transitory allocation test is similar to the Shifting allocation test (PTM 1210) except it covers the shifts that occur over a number of years.

Exception: An allocation will be treated as substantial if there is a strong likelihood that the offsetting allocation will **not** be made within 5 years after the original allocation is made (determined on a first-in, first-out basis).

Example 1*: Bob and Marion form a general partnership to acquire and lease 5-year-recovery property (under § 168). Each contributes $10,000 and the partnership borrows $80,000 to purchase the property. The partnership agreement contains all requirements regarding the maintenance of partners' capital accounts, the liquidation distribution pursuant to the partners' positive capital account balances, and the deficit capital account restoration obligation in accordance with § 704(b) regulations. In addition, the partnership agreement also provides that:*

1. *The partnership's net taxable loss will be allocated 90% to Bob and 10% to Marion until the partnership has net taxable income,*
2. *The partnership's net taxable income will be allocated 90% to Bob and 10% to Marion until Bob's allocated taxable income is equal to his previously allocated net taxable loss,*
3. *All partnership's net taxable income or loss will be allocated equally between Bob and Marion thereafter, and*
4. *Distributions of operating cash flow will be made equally to the two partners.*

The partnership entered into a 12-year lease with a corporation. The partnership's expected income and loss for the life of the lease is as follows:

- *Net taxable loss from year 1 through 5: ($10,000), ($9,000), ($8,000), ($7,000), and ($6,000), respectively.*
- *Net taxable income from year 6 through 12: $4,000, $5,000, $6,000, $7,000, $8,000, $9,000, and $10,000, respectively.*

*Even though there is a strong likelihood that the allocation of losses in years 1 through 5 will be offset by the income in years 6 through 12 and even if it is assumed that the total tax liability of Bob and Marion in years 1 through 12 will be less than if there are no such allocations, the economic effect of these special allocations is substantial under the above exception rule. This is because at the time such allocations became part of the partnership agreement, there was a strong likelihood that the allocation of losses in year 1 through 5 would not be offset by allocations of income **within 5 years**, determined on a first-in, first-out method. The year 1 allocation of $10,000 loss will not be offset until years 6, 7, and 8 ($4,000 in year 6, $5,000 in year 7, and $1,000 in year 8) and the year 2 allocation of $9,000 loss will not be offset until years 8 and 9 ($5,000 in year 8 and $4,000 in year 9), etc. [See Treas. Reg. § 1.704-1(b)(5) Example (2).]*

***Example 2**: Cynthia and Larry are equal partners in CL partnership, which is engaged in producing tax research for a state agency. Cynthia and Larry share equally in all of the partnership's income, loss, and deduction. The partnership agreement contains all the requirements regarding capital account maintenance, liquidating distribution, and deficit capital account restoration as provided by the § 704(b) regulations. In 1995, Cynthia and Larry decided to invest $50,000 in tax-exempt bonds and another $50,000 in corporate stock for the next three years. Cynthia and Larry are expected to be in the 31% and 15% tax brackets, respectively, during these three years. At the time the investment decision is made, Cynthia and Larry agree that during the 3-year period, the income and loss from these investments will be allocated as follows:*

	Cynthia	*Larry*
Interest on tax-exempt bonds	*90%*	*10%*
Gain/loss on sale of bonds	*90%*	*10%*
Dividend from corporate stock	*10%*	*90%*
Gain/loss on sale of stock	*10%*	*90%*

*Also, at the time the allocations concerning these investments become part of the partnership agreement, there is **not** a strong likelihood that the gain or loss from* *the sale of the corporate stock will be **substantially equal** to the gain or loss on the sale of the tax-exempt bonds. However, there is a strong likelihood that the tax-exempt interest and the stock dividends for the next three years will not differ substantially.*

Do these allocations have economic effect? Yes, because the partnership agreement contains all the economic effect requirements under § 704(b) regulation.

*Do the allocations of gain or loss on the **sale** of bonds and stock have **substantial** economic effect? Yes, since at the time the allocation decision becomes part of the partnership agreement, there is **not** a strong likelihood that the gain or loss on sale of the bonds will be substantially equal to the gain or loss on the sale of stock. Thus, the increases or decreases in the partners' capital accounts will differ substantially with the special allocation. For instance, assuming the gain on the sale of the bonds is $5,000 and the gain on the sale of the stock is $15,000. Cynthia's and Larry's capital accounts based on the special allocations will be increased by the following:*

	Cynthia	Larry	Total
Bonds (90/10 to Cynthia/Larry)	$4,500	$500	$ 5,000
Stock (10/90 to Cynthia/Larry)	1,500	13,500	15,000
Total Increases	$6,000	$14,000	$20,000

Without the special allocation, Cynthia's and Larry's capital account increases will be as follows:

	Cynthia	Larry	Total
Bonds (50/50 to Cynthia/Larry)	$2,500	$2,500	$5,000
Stock (50/50 to Cynthia/Larry)	7,500	7,500	15,000
Total Increases	$10,000	$10,000	20,000

It should be noted that the purpose of the substantial effect test is to prevent allocations that cause different after-tax economic consequences without causing any substantial differences in the capital accounts. (See Example in PTM 1210*). In this example, Cynthia's and Larry's capital accounts are substantially different under the special allocation. Thus, the allocations of the gain on the sale of the bonds and stock are substantial.*

*Do the allocations of the tax-exempt interest and the dividends have substantial effect? There is a strong likelihood that the tax-exempt interest and the stock dividend for the next three years will **not** differ substantially. Thus, assuming the* *total interest income equal the dividend, which is $10,000. The capital accounts of the partners under the special allocation will be as follows:*

	Cynthia	*Larry*	*Total*
Bonds (90/10 to Cynthia/Larry)	*$9,000*	*$1,000*	*$10,000*
Stock (10/90 to Cynthia/Larry)	*1,000*	*9,000*	*10,000*
Total Increases	*$10,000*	*$10,000*	*$20,000*

Without the special allocation, Cynthia and Larry will share equally in the $10,000 tax-exempt interest income and $10,000 dividend. Thus, their capital account will be increased by the same amount: $10,000. As a result, the first condition of the transitory test is met: the increases in the partners' capital account are the same with or without the allocation. The second condition of the test is whether the total tax liability under the special allocation is less than the total tax liability with no special allocation.

With the special allocation, Cynthia's tax liability on the $1,000 dividend will be $310 ($1,000 x 31%) and Larry's tax liability on the dividend will be $1,350 ($9,000 x 15%) to give a total of $1,660. Without the special allocation, Cynthia's tax liability on the $5,000 dividend will be $1,550 ($5,000 x 31%) and Larry's tax liability on the dividend will be $750 ($5,000 x 15%) to give a total tax liability of $2,300. Thus, the total tax liability under the special allocation ($1,660) is much less than the total tax liability without the special allocation ($2,300). As a result, the special allocation does not have substantial effect because (1) it causes no substantial differences in the partners' capital accounts and (2) the total tax liability is substantially less than without the special allocation. [See Treas. Reg. § 1.704-1(b)(5) Example (7)(i).]

***Observation**: Note that the transitory test applies to the three-year period while the shifting of income test applies to one year only. However, the underlying principle of the substantial effect is the same: if an allocation causes no difference in the partners' capital account but the total partners' tax liability is less than the total tax liability if there is no special allocation, such special allocation has no substantial effect.*

1300 MAINTENANCE OF CAPITAL ACCOUNTS

In general, a partner's capital account reflects his equity (economic) interest in the partnership.

- If a partner's capital account has a positive balance, it usually indicates the proceeds the partner will receive if his partnership interest is liquidated.

- If a partner's capital account has a negative balance, it may indicate that the partner has to make an additional contribution to the partnership if his partnership interest is liquidated.

Based on how they are prepared, there are several "types" of capital accounts: Tax basis capital accounts (See PTM 1310), IRC § 704(b) capital accounts (See PTM 1320), IRC § 704(c) capital accounts (See PTM 1330), and financial capital accounts based on generally accepted accounting principles (GAAP) (See PTM 1340).

PTM 1310	Tax-Basis Capital Accounts
PTM 1320	IRC § 704(b) Capital Accounts
PTM 1330	IRC § 704(c) Capital Accounts
PTM 1340	Financial Capital Accounts

1310 Tax-Basis Capital Accounts:

In general, tax basis capital accounts are prepared based on the "tax" basis amounts (as opposed to "book" amounts or fair market values). The adjustments to tax-basis capital accounts are based on the **tax-basis amounts** determined under **tax law**.

Initial tax basis capital account:

- Cash contributed to the partnership or used to acquire the partnership interest. If a property is contributed to the partnership, the partner's tax basis capital account is increased by the partner's **adjusted tax basis** in the property, less any encumbered liability assumed by the partnership. (The fair market value of the contributed property has no bearing on the tax basis capital account.)

- If a partner acquires an interest in a partnership from another partner, he usually "assumes" the tax-basis capital account of the selling partner, unless he elects to step-up his tax basis capital account under IRC § 754 basis adjustments (See PTM 1500).

A partner's initial tax basis capital account is increased by:
- Any additional contributions to the partnership by the partner of cash and the tax basis of property ,
- the partner's distributive share of taxable income and tax-exempt income, including the income from a cancellation of debt (COD) regardless of whether or not the COD income is excluded by the partners under various provisions of IRC §108. (it isn't discussed later in the current chapters of the manual.)

A partner's tax basis capital account is decreased by:
- the amount of cash and the tax basis of property distributed from the partnership to the partner,
- the partner's distributive share of taxable losses and the partnership's nondeductible expenses (e.g., political contributions, premium payment on partners' life insurance, etc.)

In many ways, the computation of a partner's tax basis capital accounts is similar to the computation of the partner's basis in his partnership interest (See PTM 5000). The primary difference is that a partner's tax basis capital account does not include his share of partnership liabilities or the basis adjustments under § 754 if no such election is made by the partnership. Thus, a shortcut to computing a partner's basis in his partnership interest is to add his share of partnership liabilities to the balance of his tax basis capital account and adjust for any inside and outside basis differences (inside basis: partner's share of partnership's basis in partnership property; outside basis: partner's basis in his/her partnership interest.)

When a partner's interest in a partnership is liquidated, his negative tax basis capital account usually indicates the amount of capital gain he will recognize from the liquidation.

Example 1*: Paul and Kathy form a general partnership. Paul contributes $30,000 cash and Kathy contributes rental property with a fair market value of $35,000 and an adjusted basis of $20,000. The property is encumbered by a mortgage of $5,000. During the first year, the partnership generates a rental loss of ($1,000) and tax-exempt interest income of $3,000. The partnership also* *makes a distribution of $4,000 to each partner. The **tax basis** capital accounts and Paul's and Kathy's outside basis are as follows:*

	Paul		Kathy	
	Cap. Acct.	Basis	Cap. Acct.	Basis
Cash Contribution	$30,000	$30,000	0	0
Property Contribution	0	0	$20,000	$20,000
Less: Relieved Liability	0	0	(5,000)	(5,000)
Add: Assumed Liability	0	2,500	0	2,500
Interest Income	1,500	1,500	1,500	1,500
Rental Loss	(500)	(500)	(500)	(500)
Distributions	(4,000)	(4,000)	(4,000)	(4,000)
Year End Balances	$27,000	$29,500	$12,000	$14,500

Note that the sole difference between the partners' capital accounts and their partnership bases is the liability of $2,500. This liability comes from the $5,000 mortgage on the rental property and assumed by the partnership. The liability is shared equally by Paul and Kathy.

Kathy's capital account is increased by her adjusted basis in the contributed property, $20,000, less the liability assumed by the partnership, $5,000.

***Example 2**: Assume the same facts as in Example 1 except that at the beginning of year two, Paul sells his interest in the partnership to Sam for $30,000 cash. Paul's gain on the sale of his interest is as follows:*

Amount Realized:	
Cash	$30,000
Add: Liability assumed by buyer	2,500
Less: Basis in partnership interest	(29,500)
Gain	$3,000

Sam's "outside basis" in the partnership:

Cash paid	$30,000
Liability Assumed	2,500
Initial Outside Basis	$32,500

Sam's "inside basis" in the partnership, however, is Paul's basis in the partnership, which is $29,500. Thus, if the partnership has § 754 election in effect, Sam's inside basis may be adjusted to equal his outside basis.

Sam's initial capital account is Paul's capital account, which is $27,000. However, since he paid $30,000 for the interest, his capital account may be increased to $30,000 under § 743 if the partnership has a § 754 election in effect.

***Observation**: Another shortcut to computing potential gain or loss on a disposition of a partnership interest is by subtracting the partner's tax basis capital account from the cash received. In the above example, the difference between Paul's tax capital account balance ($27,000) and the cash he receives ($30,000) reflects the gain of $3,000. If Paul's capital account were negative, say ($2,000), the gain would be $32,000.*

In general, the partnership is required to report § 704(b) capital accounts on Form 565 and the partners' schedule K-1. In many instances, the partners' tax basis capital accounts are similar to their § 704(b) capital accounts (see PTM 1320). However, for determining a partner's gain or loss on the liquidation or the disposition of his interest in the partnership, the auditor needs to request the partner to compute his basis in the partnership. The above shortcut method is for purposes of estimating potential gain or loss, assuming the auditor knows the partner's tax basis capital account.

Although the partnership is required to maintain § 704(b) capital accounts for purposes of allocation of partnership income and loss, it also maintains tax basis capital accounts for purposes of tracing partners' tax bases in their partnership interests.

1320 IRC § 704(b) Capital Accounts

Partnerships' allocation of income or loss to their partners must have substantial economic effect, as provided under § 704(b) regulations. To measure the economic effect of partnerships' allocations, partners' capital accounts are required to be maintained in accordance with certain rules prescribed under the § 704(b) regulations to reflect the economic value of the partners' interest. Thus, the main purpose of the § 704(b) capital accounts is to trace the partners' real economic interests in the partnership, rather than their tax bases.

To reflect the real economic value of partners' interests in the partnership, § 704(b) capital accounts are prepared based on the **fair market value** of the interests. For instance, if a partner contributes a property to the partnership, his § 704(b) capital account will be increased by the fair market value of the property, rather than by the partners' adjusted tax basis in the property. (See the maintenance rules regarding § 704(b) capital accounts discussed in PTM 1320.)

Terminology: Since § 704(b) capital accounts are based on the fair market value of the property, they are also referred to as "book" capital accounts in the Regulations. Also, the difference between the tax-basis capital accounts and § 704(b) "book" capital accounts is commonly referred to as the "book/tax" disparity in the Regulations. **It is important to note that the terms "book", "book value", 'book income" and "book loss" used in the Regulations have nothing to do with the partnership's books of accounts kept for financial accounting purposes or the income or loss computed based on financial accounting principles.** One of the primary differences between § 704(b) "book" capital accounts and the capital accounts prepared for financial accounting purposes is that the adjustments to the § 704(b) capital accounts are based on federal income tax principles (e.g., depreciation deductions based on tax law), **not** financial accounting principles (e.g., depreciation deductions using generally accepted accounting principles).

In §§ 1000 -- §§ 3500, unless specified otherwise, the term "capital account(s)" implies the § 704(b) capital accounts and the term "book" is understood within the context of § 704(b) regulations rather than of the financial accounting principles.

1330 IRC § 704(c) Capital Accounts

IRC § 704(c) provides that if at the time a property is contributed to the partnership, its adjusted tax basis is different than its fair market value, this difference has to be allocated to the contributing partner. As a result, the partnership has to keep track of this pre-contribution gain or loss for the purpose of allocation purposes.

A detailed discussion of §704(c) capital account is provided in PTM 2100.

1340 Financial Capital Accounts

Certain partnerships may maintain their partners' capital accounts based on generally accepted accounting principles[3] (GAAP) for financial accounting purposes (such as publishing their financial statements.) Though GAAP capital accounts may be similar to § 704(b) capital accounts (e.g., contributed property recorded at fair market value, revaluation of partnership assets, etc.), they are not the same. Therefore, GAAP capital accounts should not be used for § 704(b) allocation purposes.[4]

1400 BASIC CAPITAL ACCOUNT MAINTENANCE RULES

In general, under the § 704(b) regulations, a partner's capital account is increased by: [Treas. Reg. § 1.704-1(b)(2)(iv)(b)]

- the amount of money contributed to the partnership (See PTM 1410),
- the fair market value of the property contributed to the partnership, net of any encumbering liabilities assumed by the partnership pursuant to § 752 rules (See PTM 1420),
- the partner's distributive share of partnership income and gain, including income exempt from tax,
- the book (not tax) income and gain with respect to property whose adjusted tax basis differs from its fair market value (See PTM 1460), and
- unrealized income with respect to accounts receivable and other accrued but unpaid items.

A partner's capital account is decreased by:

- the amount of money distributed by the partnership to the partner (See PTM 1410),
- the fair market value of property distributed by the partnership to the partner, net of any encumbering liabilities assumed by the distributee partner pursuant to § 752 rules (See PTM 1420),
- the partner's distributive share of partnership losses and deductions and the partnership expenditures that are neither deductible by the partnership in computing its taxable income nor properly chargeable to capital accounts (such as syndication costs under § 709(b), organization costs not elected by the partnership for amortization and losses recognized by the partnership on sales of its assets but are not deductible due to the related party rules under §§ 267(a)(1) and 707(b)),
- book (not tax) losses and deductions with respect to property whose its adjusted tax basis differs from its fair market (book) value,
- unrealized deductions with respect to accounts payable and other accrued but unpaid items, and
- excess percentage depletion regarding depletable property (not discussed in §§ 1000 – §§ 3500)

The above increases and decreases are determined at the partnership level (See PTM 1520).

Single Capital Account: If a partner has more than one interest in the partnership, he will be treated as having a single capital account that reflects all such interests, regardless of the class of the interest (general or limited) and regardless of the time or manner in which such interests are acquired. [Treas. Reg. § 1.704-1(b)(2)(iv)(b)]

***Observation**: The above adjustments to capital accounts may be complicated in certain circumstances. Please refer to the reference paragraphs for detailed explanations.*

PTM 1410 Assumption of Liabilities
PTM 1420 Contributions and Distributions of Property
PTM 1425 IRC § 704(c) Considerations
PTM 1430 Contributions of Promissory Notes
PTM 1440 Distribution of Promissory Notes
PTM 1450 Revaluation of Property
PTM 1460 Adjustments to Reflect Book Value
PTM 1470 Determination of Fair Market Value
PTM 1480 IRC § 705(a)(2)(B) Expenditures
PTM 1490 Organization and Syndication Fees (§ 709 Expenses)
PTM 1495 Disallowed Losses

1410 Assumption of Liabilities

- For purposes of § 704(b) capital accounts, a partner's capital account is increased by the amount of money contributed by such partner to the partnership and decreased by the amount of money distributed by a partnership to such partner.

- If a partner **personally assumes** a partnership liability, the assumed liability is treated as a cash contribution. If the partnership assumes **a partner's personal liability**, the assumed liability is treated as a cash distribution by the partnership to such partner.

Assumption Rules: For purposes of § 704(b) capital accounts, liabilities are considered assumed only to the extent:

- the assuming party is thereby subject to <u>personal liability</u> with respect to such obligation,
- the creditor is aware of the assumption and can <u>directly enforce</u> the obligation of the assuming party, and

- the assuming party is ultimately liable for the obligation. [Treas. Reg. § 1.704-1(b)(2)(iv)(c)]

Note:
The assumption of liabilities for purposes of § 704(b) is similar to the assumption rules of § 752. [Treas. Reg. § 1.752-1(d)] However, it is important to distinguish between an assumption of liabilities and a share of partnership liabilities under § 752. A partner's share of partnership liabilities under § 752 is treated as a constructive cash contribution by such partner and therefore increases his basis in the partnership interest. However, under § 752, the liabilities remain partnership liabilities (i.e., the partnership continues to make payments on principal and interest of the liability) as opposed to a partner being liable for payments of principal and interest on a liability that the partner personally assumes. The liability is no longer a partnership liability. The increases or decreases in a partner's share of partnership liabilities under § 752 has no effect on the partner's capital account. [*Treas. Reg. § 1.752-1(d)] On the contrary, when a partner personally assumes a partnership liability or when the partnership assumes a partner's liability, his capital account is increased or decreased, respectively, by such liability.*

A true assumption is a novation of the contract where the obligee releases the original obligor and looks solely to the new obligor for satisfaction of the obligation. The auditor must be careful to distinguish between a real "assumption" and a sloppy guarantee.

***Example**: In exchange for a 10% interest in a partnership, Debbie and the partnership incur the following transactions:*

- *Debbie contributes to the partnership a rental property with an adjusted basis of $30,000 and a market value of $50,000. The property is encumbered by a recourse mortgage of $20,000.*
- *The partnership owes Debbie's father $1,000. Debbie agrees to assume payments on this $1,000 liability.*

Debbie's capital account under §704(b) is as follows:

Market Value of Contributed Property	*$50,000*
Less: Encumbering liabilities assumed by the partnership	*(20,000)*
Add: Personally Assumed Liability	*1,000*
Balance at Contribution	*$31,000*

***Observation**:*

- *Debbie's book capital account is first increased by $50,000, the fair market value of the contributed property (See* PTM 1420*).*
- *The encumbering mortgage of $20,000 is assumed by the partnership and therefore is treated as a cash distribution which decreases Debbie's capital account. (Note that when a property subject to a liability is contributed by a partner to the partnership or distributed by the partnership to a partner, the transferee is treated as having assumed the encumbering liability to the extent that the liability does not exceed the fair market value of the property. [Treas. Reg. § 1.752-1(e)]) After the $20,000 liability becomes a partnership liability, Debbie's share of the liability (10%) under the sharing rules of § 752 only affects her basis in the partnership, not her capital account. (See* PTM 5400*: Partnership Liabilities)*
- *Since Debbie personally assumes the partnership's $1,000 liability, she is treated as making a contribution of $1,000 in cash to the partnership.*
- *In applying the assumption rule of § 704(b), Debbie's assumption of the $1,000 liability can only be treated as a cash contribution if (1) she is personally liable for making payment on the liability, (2) her father (the creditor) is aware of the assumption and can legally enforce the obligation against her and require her to make payments on the liability, and (3) Debbie, not the partnership, is ultimately liable for the $1,000 liability. It should be noted that the key to this assumption of liability is the fact that Debbie personally takes over payments on the liability. If Debbie merely guarantees payments on the liability alone while the partnership continues to make payments, the guarantee is not treated as an assumption under § 704(b) and therefore does not increase Debbie's capital account (though under § 752, the entire $1,000 liability is allocated to Debbie due to her personal guarantee.)*

1420 Contribution and Distribution of Property

In general, for purposes of § 704(b), a partner's capital account is increased by the **fair market value** of property contributed to the partnership on the date of contribution. [Treas. Reg. § 1.704-1(b)(2)(iv)(d).] A partner's capital account is decreased by the **fair market value** of property distributed by the partnership to such partner, whether in connection with a liquidation or otherwise. [Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1) and (d)(1).]

The use of the fair market value rather than the tax basis is to prevent the shifting of pre-contribution gain or loss to partners other than the contributing partner. For a determination of fair market value, See PTM 1470.

If the contributed or distributed property is subject to non-recourse liabilities, the requirement under § 7701(g) does **not** apply. [Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1) and (d)(1).] (IRC § 7701(g) requires that for purposes of determining the amount of gain or loss with respect to any property, the fair market value of such property shall be treated as not less than the amount of any non-recourse indebtedness to which such property is subject.) (See PTM1460)

If a property is distributed to a partner, additional adjustments must first be made to the capital accounts of all partners to reflect the manner in which the unrealized income, gain, loss and deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable distribution of such property for the fair market value of such property on the date of distribution. These adjustments are made prior to decreasing the recipient partner's capital account. Note that for purposes of this paragraph, the requirement of § 7701(g) mentioned in the immediate paragraph applies. [Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1) and (d)(1).] For illustration, see PTM 1450, Example 5.

1425 IRC § 704(c) Considerations

If a partner contributes a property to a partnership and the partnership's basis in the property is different from the property's fair market value, the partnership is required to maintain the partners' capital accounts in accordance with the rules provided in § 1.704-1(b)(2)(iv)(g). (See PTM 1460)

1430 Contribution of Promissory Notes

If a promissory note is contributed to a partnership by a partner who is the maker of the note, the principal amount of the note does **not** increase the partner's capital account until there is a taxable distribution of such note by the partnership or when the partner makes principal payments on such note.[5]

However, in certain rare situations, if the note is readily tradable on an established securities market, the contributing partner's capital account may be increased immediately by the fair market value of the note. [Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1) and (d)(1)]

Observation: *All notes are negotiable unless explicitly made non-negotiable (i.e., cannot be sold, transferred, hypothecated, pledged as collateral, etc.) With regard to whether a note is readily tradable on an established securities market, it is a non-existent ability. The reason is that the established securities markets, such as NASDAQ, etc., only sells very high quality stuff. The only notes having* *such qualities are corporate bonds. Thus, if IBM is the partner, it could use its note (bond) and qualify*.

If a partner liquidates his partnership interest and contributes a promissory note to the partnership to satisfy his obligation to restore the deficit capital account balance, he is treated as satisfying the deficit balance to the extent of:

- the fair market value, at the **time of contribution**, of the negotiable note that he contributes to the partnership within the time permitted under the deficit capital account restoration rules (90 days) and
- the fair market value, at the **time of liquidation**, of the unsatisfied portion of any negotiable notes that he *previously* contributed to the partnership.

For purposes of the rules in this paragraph, the fair market value of the note will be no less than the outstanding principal balance of such note, provided such note bears interest at no less than the applicable federal rate at the time of valuation. [Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1) and (d)(1)]

1440 Distribution of Promissory Notes

If a promissory note is distributed to a partner by the partnership who is the maker of the note, such partner's capital account will be decreased by the amount of such note only when:

- there is a taxable disposition of such note by the partner or
- the partnership makes principal payments on the note. However, if the note is readily tradable on an established securities market, the distributee partner's capital account may be adjusted downward immediately.

If the partner's interest in the partnership is liquidated, his capital account will be reduced to the extent of:

- the fair market value, at the time of distribution, of any negotiable promissory note distributed by the partnership to such partner within the time permitted in the law (§ 1.704-1(b)(2)(ii)(b)(2)), and
- the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note that the partnership previously distributed to the partner.

The fair market value of a note will be no less than the outstanding principal balance of such note, provided the note bears interest at a rate no less than the applicable federal rate[6] at the time of valuation. [Treas. Reg. § 1.704-1(b)(2)(iv)(e)(2)]

1450 Revaluation of Property

A partnership agreement may provide that, upon the occurrence of certain events, the partners' capital accounts will be adjusted to reflect a revaluation of partnership property (including tangible assets such as goodwill) on the partnership's books if the adjustments are made principally for a substantial **non-tax business purpose**. A revaluation may occur:

- In connection with a contribution of money or other property (other than a de mininis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership,
- In connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, and
- Under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market. [Treas. Reg. § 1.704-1(b)(2)(iv)(f)]

To be in compliance with the maintenance rules of § 1.704-1(b)(2)(iv), the partners' capital accounts must be adjusted in the following manner:

- The adjustments are based on the <u>fair market value</u> of partnership property on the date of adjustment (taking § 7701(g) into consideration),
- The adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital account previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date,
- The partnership agreement must require that the partners' capital accounts be adjusted in accordance with the rules provided in § 1.704-1(b)(2)(iv)(g). (See PTM 1460) regarding depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with regard to such property, and
- The partnership agreement must require that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as

> computed for tax purposes, with respect to such property, be determined so as to take account of the variation between the adjusted tax basis and book value (FMV) of such property in the same manner as under § 704(c) (See PTM 1640).

If the capital accounts of the partners are **not** adjusted to reflect the fair market value of the partnership property when an interest in the partnership is acquired from or relinquished to the partnership, the potential tax consequences should be based on §1.704-1(b)(1)(iii) and (iv) [Treas. Reg. § 1.704-1(b)(2)(iv)(f)(iii)] (See PTM 1060).

Note: Item (1) above is limited by the provision of § 7701(g) that provides that the fair market value of a property cannot be less than the amount of non-recourse liability that the property is subject to. Thus, property being re-valued cannot be booked down below the outstanding balance of the non-recourse liability.

***Example 1**: Anthony and Ted form a partnership to which each contributes $10,000. The partnership invests the $20,000 in securities of Instant News Inc. (which are not readily tradable on an established securities market). The partnership agreement contains all the provisions regarding maintenance, distribution and restoration of partners' capital accounts as required by § 1.704-1(b)(2)(iv) (*See PTM 1120*). Assume there is no operating income or expense during the first year. At the beginning of the second year, Vengie, a new partner, makes a cash contribution of $25,000 in exchange for one-third interest in the partnership. At the time of Vengie's admission, the securities of Instant News Inc. have a fair market value of $50,000. Immediately after the admission, the partnership sold the securities for its fair market value that results in a taxable gain of $30,000. Pursuant to the above requirements, the (book) capital accounts of Anthony and Ted must be adjusted to reflect the difference between the fair market value and the adjusted basis of the partnership property at the time of Vengie's admission. After the sale, their capital accounts are also adjusted as follows:*

	Anthony		*Ted*		*Vengie*	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Cap. acct. before admission	*$10,000*	*$10,000*	*$10,000*	*$10,000*	*0*	*0*
Book adjustment following ad	*0*	*15,000*	*0*	*15,000*	*$25,000*	*$25,000*
Cap. acct. after admission	*$10,000*	*$25,000*	*$10,000*	*$25,000*	*$25,000*	*$25,000*

Adjustments for taxable gain	*$15,000*	*0*	*$15,000*	*0*	*0*	*0*
Cap. Acct. after sale	*$25,000*	*$25,000*	*$25,000*	*$25,000*	*$25,000*	*$25,000*

***Observation**: Anthony's and Ted's § 704(b) "book" capital accounts are adjusted to reflect the fair market value of the partnership assets at the time Vengie is admitted to the partnership. Their tax basis capital accounts are not affected by the book gain (which is computed based on the difference between the adjusted tax basis and the fair market value of the securities).*

*The taxable gain of $30,000 on the sale of the securities is allocated to Anthony and Ted pursuant to § 704(c) (because the gain represents the appreciation of the securities prior to Vengie's admission) (*See PTM 2100*) and adjustments are made to their tax basis capital accounts to reflect the taxable gain*. [*See Treas. Reg. § 1.704-1(b)(5) Example (14)(i).]*

***Example 2**: Assume the same facts as in Example 1 except that after Vengie's admission to the partnership, the securities appreciate to $77,000 and are sold, resulting in a taxable gain of $57,000 ($77,000 less $20,000 tax basis) and a book gain of $27,000 ($77,000 less $50,000 book basis). This gain includes $30,000 appreciation before Vengie's admission and $27,000 appreciation after her admission. Pursuant to the above requirements and the requirements under § 704(c) Regulations, the $30,000 gain is shared by Anthony and Ted and the $27,000 gain is shared equally by all three partners. Their capital accounts are adjusted as follows:*

	Anthony		***Ted***		***Vengie***	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Cap. acct. before admission	*$10,000*	*$10,000*	*$10,000*	*$10,000*	*0*	*0*
Book adj. following adm.	*0*	*15,000*	*0*	*15,000*	*$25,000*	*$25,000*
Cap. acct. after admission	*$10,000*	*$25,000*	*$10,000*	*$25,000*	*$25,000*	*$25,000*
Adjustments for tax/book gain	*$24,000*	*9,000*	*$24,000*	*9,000*	*9,000*	*9,000*
Cap. Acct. after sale	*$34,000*	*$34,000*	*$34,000*	*$34,000*	*$34,000*	*$34,000*

***Observation**: The $24,000 tax gain adjustments to Anthony's and Ted's tax-basis capital accounts reflects the pre-admission gain of $15,000 and the post-*

admission gain of $9,000. However, their § 704(b) 'book" capital accounts are adjusted twice to reflect the book gain at the admission and the book gain at the sale. [*See Treas. Reg. § 1.704-1(b)(5) Example (14)(ii).]*

Example 3*: Assume the same facts as in Example 1 except that after Vengie's admission, the securities depreciated to $38,000 and are sold for the same amount, resulting in a taxable gain of $18,000 and a book loss of $12,000 ($38,000 less $50,000 book basis). The taxable gain of $18,000 is allocated to Anthony and Ted. The book loss of $12,000 is shared equally by the three partners. Their capital accounts are adjusted as follows:*

	Anthony		***Ted***		***Vengie***	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Cap. acct. before admission	*$10,000*	*$10,000*	*$10,000*	*$10,000*	*0*	*0*
Book adjustment following adm.	*0*	*15,000*	*0*	*15,000*	*$25,000*	*$25,000*
Cap. acct. after admission	*$10,000*	*$25,000*	*$10,000*	*$25,000*	*$25,000*	*$25,000*
Adjustments for tax gain	*9,000*	*0*	*9,000*	*0*	*0*	*0*
Adjustments for book loss	*0*	*(4,000)*	*0*	*(4,000)*	*0*	*(4,000)*
Cap. Acct. after sale	*$19,000*	*$21,000*	*$19,000*	*$21,000*	*$25,000*	*$21,000*

Observation*: In this example, Vengie bears an economic loss of $4,000 without a corresponding taxable loss due to the "ceiling rule" (discussed in* PTM 2010*). [See Treas. Reg. § 1.704-1(b)(5) Example (14)(iii).]*

Example 4*: Assume the same facts as in Example 2 except that after Vengie's admission to the partnership, the capital accounts of Anthony and Ted are* ***not*** *adjusted upward to $25,000 to reflect the appreciation in the securities held by the partnership during the period before Vengie's admission. However, after Vengie's admission, the partnership agreement is amended to provide that the first $30,000 of taxable gain upon the sale of the securities will be allocated equally between Anthony and Ted, and that all other income, gain, loss, and deduction will be allocated equally among the three partners. When the securities are sold for $77,000, the $57,000 of taxable gain is allocated in accordance with the amended partnership agreement. The allocations have substantial economic effect. [See Treas. Reg. § 1.704-1(b)(5) Example (14)(iv).]*

Example 5*: Assume the same facts as Example 4 except that instead of selling the securities, the partnership makes a distribution of the securities which have a* *fair market value of $77,000. Assume the distribution does not give rise to a § 707(a)(2)(B) transaction.[7] Pursuant to the requirements under § 1.704-1(b)(2)(iv)(e)(1) (See* PTM 1420*), the partners' capital accounts are adjusted immediately prior to the distribution to reflect how the taxable gain ($57,000) would have been allocated had the securities been sold for their fair market value ($77,000). Thus, the capital accounts of all partners are adjusted with reference to the $77,000 "book-up" value. [See Treas. Reg. § 1.704-1(b)(5) Example (14)(v).]*

	Anthony	*Ted*	*Vengie*
Book Cap. acct. before adjustments	*$10,000*	*$10,00*	*$25,000*
Deemed sale adjustments	*24,000*	*24,000*	*9,000*
Less: Distribution	*(25,667)*	*(25,667)*	*(25,667)*
Cap. Acct. after distribution	*$8,333*	*$8,333*	*$8,333*

1460 Adjustments to Reflect Book Value

When a property is contributed to a partnership (See PTM 1420), or when the partnership property is re-valued (See PTM 1450), the fair market value (book value) of such property, as recorded on the books of the partnership, may be different from its adjusted tax basis. Thus, the amounts of depreciation, depletion, amortization, and gain or loss computed for books with regard to such property may be different from the amounts computed for tax. In these circumstances, the regulations under § 704(b) and (c) provide that **the capital accounts of the partners have to be adjusted for the allocations to them of depreciation, depletion, amortization, and gain or loss as computed for book purposes** (**not** for tax purposes) with regard to such property. (Note that the same principle applies under the basic capital account maintenance rules (See PTM 1400): when the fair market value of a property differs from its adjusted tax basis, the partners' capital accounts are adjusted by the book income or gain.)

In addition, the partners' capital accounts may **not** be further adjusted by their share of the corresponding items computed for tax purposes (See the Observation in PTM 1460, Example 2).

The allocation of those book items must be in accordance with the following rules:

- In determining whether the economic effect of the allocation of the book items (depreciation, depletion, amortization, gain or loss) is substantial, the partnership should consider the effect of such allocation on the allocation of the corresponding tax items under § 704(c). If the allocation of the book items under the partnership agreement does not have substantial economic effect or is not respected under § 1.704-1(b)(2)(ii) and (b)(2)(iii), these items will be reallocated in accordance with the partners' interests in the partnership, and such reallocation will be the basis upon which the partners' distributive shares of the corresponding tax items are determined under § 704(c) and § 1.704-1(b)(4)(i). [Treas. Reg. § 1.704-1(b)(2)(iv)(g)(1)] (see *Example 1,* PTM 1460)

- Determining the amount of book items: the amount of book depreciation, depletion, or amortization must bear the same relationship to the book value of such property as the depreciation (or cost recovery deduction), depletion, or amortization computed for tax purposes bears to the adjusted tax basis of such property. For example, if the contributed property has an adjusted tax basis of $200 and a fair market value of $500 and is subject to a three-year cost recovery deductions in the amounts of $60 (30%), $100 (50%), and $40 (20%), the corresponding book depreciation deductions are $150, $250, and $100. If the property has a zero adjusted tax basis, the book depreciation, depletion, or amortization may be determined under any reasonable method selected by the partnership. [Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3).]

Example 1*: Stan and Jennifer form a partnership with Stan contributing $10,000 in cash and Jennifer contributing a property with an adjusted tax basis of $8,000 and a fair market value of $10,000. The property has 2 years of cost recovery deductions remaining. The partnership agreement contains all the requirements under the capital account rules of § 1.704-1(b)(2)(iv). Stan expects to be in a substantially higher tax bracket than Jennifer in the partnership's first taxable year. In the second partnership taxable year, both of them are expected to be in equivalent tax brackets. The partnership agreement provides that all items are allocated equally except that all $5,000 of book depreciation is allocated to Stan in the first partnership taxable year and Jennifer will be allocated all $5,000 of book depreciation in the second partnership taxable year. If the allocation of the book depreciation to Stan in the first year is respected, Stan will be entitled to the entire cost recovery deduction of $4,000 for such year under § 704(c). In the same manner, Jennifer will be allocated the cost recovery deduction of $4,000 in the second year. (Note the general principle of partnership allocations is that tax allocations must follow book allocations. Thus, if the entire book depreciation of $5,000 is allocated to Stan in the first year, he must also be allocated the entire corresponding tax depreciation of $4,000. The same principle applies in year two with regard to Jennifer.)*

The issue is whether those special allocations of book depreciation (and the corresponding tax depreciation) to Stan and Jennifer in the first and second years, respectively, have substantial economic effect.

First, since the partnership agreement contains all three requirements under the economic effect test (See PTM 1120*), the above special allocations have economic effect.*

However, ***the economic effect is not substantial*** *since there is a strong likelihood that at the time such allocations became part of the partnership agreement that, at the end of the two-year period to which such allocations relate, the net increases and decreases to Stan's and Jennifer's capital accounts will be the same with such allocations as they would have been in the absence of such allocations while the total tax liabilities of Stan and Jennifer will be reduced (due to the allocation of cost recovery deductions under § 704(c)) as a result of the allocation of book depreciation (See* PTM 1200*). Thus, the allocations of the book depreciation in the partnership agreement will be disregarded. Stan and Jennifer will be allocated such book depreciation in accordance with their interests in the partnership (50/50) as provided above. [See Treas. Reg. § 1.704-1(b)(5) Example (17).]*

Observation*: Again, it should be remembered that allocations of tax items must follow allocations of book or economic items. In this example, the allocations of the tax depreciation pursuant to § 704(c) (due to property being contributed to the partnership with an adjusted tax basis different from its fair market value) follow the allocations of book depreciation. Thus, if the book allocation is respected under the rules of § 704(b) (i.e. the substantial economic effect test), the tax allocation (under § 704(c)) will also be respected.*

To test the "substantiality" of an allocation, it is necessary to take into account the tax effects of such allocation with regard to the partners (See PTM 1200*). Since a book allocation cannot have tax affects, the regulations provide that the tax effects of a book allocation are determined based on the corresponding tax allocation that follows such book allocation. In this example, the substantiality test is based on the effect of the allocations of the tax depreciation of $4,000 that follows the allocation of the book depreciation of $5,000. As stated above, since the book allocation fails under the substantiality test, it has to be allocated equally between Stan and Jennifer. As a result, for book purposes, the $5,000 depreciation will be reallocated equally between Stan and Jennifer in year 1 and year 2. Also, the corresponding tax depreciation of $4,000 will be allocated in accordance with the book allocation, i.e., equally to Stan and Jennifer.*

***Example 2**: Rafael and Don form a brokerage general partnership for investing and trading in securities. Rafael contributes cash of $10,000 and Don contributes securities of M Corporation, which have an adjusted basis of $4,000 and a fair market value of $10,000. The partnership agreement contains all the requirements regarding capital accounts as provided under § 1.704-1(b)(2(iv), including the obligation to restore the negative capital account balance. The partnership agreement also provides that all partnership distributions, income, gain, losses, deductions, and credits will be shared equally between Rafael and Don, except the taxable gain attributable to the pre-contribution appreciation associated with the securities of M corporation will be allocated to Don in accordance with § 704(c). During the first year, the partnership sells the securities of M corporation for $12,000, resulting in taxable gain of $8,000 ($12,000 less $4,000 adjusted tax basis) and a book gain of $2,000 ($12,000 less $10,000 book basis). The partnership has no other income or gain. The gain from the sale of the securities is allocated as follows:*

	Rafael		***Don***	
	Tax	*Book*	*Tax*	*Book*
Cap. acct. upon formation	*$10,000*	*$10,000*	*$4,000*	*$10,000*
Plus: gain	*1,000*	*1,000*	*7,000*	*1,000*
Cap. Acct. at year end	*$11,000*	*$11,000*	*$11,000*	*$11,000*

***Observation**:*

The fair market value of the contributed property (securities of M corporation) is different from its adjusted tax basis. Thus, the adjustments to Rafael's and Don's book capital accounts are based on the gain ($2,000) computed for book purposes. (The inclusion of the tax basis capital accounts above is for reference purposes. The balance sheet and the partners' capital accounts as shown on the partnership information return will reflect the book capital account amounts only.) Also, since the adjusted tax basis of the contributed securities is different from its fair market value, the allocation of pre-contribution gain and the book gain are governed by §704(c) regulations (see PTM 2010. *for detailed explanations). [See Treas. Reg. § 1.704-1(b)(5) Example (13)(1).]*

Don's book capital account is increased by the book gain of $1,000. Thus, his capital account cannot be further increased by the taxable gain of $7,000 as computed for tax purposes. The auditor should be aware of this situation since, if correctly prepared, on his Schedule K-1, Don's capital account (which is book capital account) will show an upward adjustment of $1,000 while the taxable gain is $7,000.

1470 Determination of Fair Market Value

The fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise re-valued by a partnership, will be regarded as correct, provided that: (same cite as below)

- such value is reasonably agreed to among the partners in arm's length negotiations, and
- the partners have sufficiently adverse interests.

If the above conditions are not satisfied and the value assigned to the property is overstated or understated, the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of the § 704(b) regulations. The determination of the fair market value will be on a property-by-property basis, except as permitted otherwise by the regulations under § 704(c). [Treas. Reg. § 1.704-1(b)(2)(iv)(h)]

1480 IRC § 705(a)(2)(B) Expenditures

IRC § 705(a)(2)(B) expenditures are the expenditures of the partnership which are not deductible in computing its taxable income and not properly chargeable to capital account (e.g., certain premium payments on life insurance are not deductible under § 264, meal and entertainment expenses in excess of allowable deduction (§ 274(n), etc.)

A partner's distributive share of these expenditures reduces his basis in the partnership.

Under the capital account rules, an allocation to a partner of § 705(a)(2)(B) expenditures decreases such partner's capital account. If an allocation of these expenditures does not have substantial economic effect, the expenditures will be reallocated in accordance with the partner's interest in the partnership. [Treas. Reg. § 1.704-1(b)(2)(iv)(i)(1)]

1490 Organization and Syndication Fees (§ 709 Expenses)

Organization and syndication fees (amounts paid to organize a partnership or to promote the sale of partnership interests) are treated as § 705(a)(2)(B) expenditures that are neither deductible nor capitalizable.

As a result, each partner's capital account is reduced by his distributive share of these expenditures. [Treas. Reg. § 1.704-1(b)(2)(iv)(i)(2)]

1495 Disallowed Losses

If a loss incurred in connection with the sale or exchange of partnership property is disallowed to the partnership under § 267(a)(1) (related party transaction) or §707(b) (transactions with respect to controlled partnerships), the disallowed loss will be treated as a§ 705(a)(2)(B) expenditure and will reduce the partners' capital accounts. [Treas. Reg. § 1.704-1(b)(2)(iv)(i)(3)]

1500 TRANSFER OF PARTNERSHIP INTEREST

In general, upon the transfer of all or part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner. (See PTM 1510, Example 2)

For the effect of a § 754 election on the partners' capital accounts, see PTM 1510.

If the transfer of an interest in a partnership causes a termination of the partnership under § 708(b)(1)(B), the capital account that carries over to the transferee partner will be adjusted in accordance with § 1.704-1(b)(2)(iv)(e) and the constructive liquidation rules under § 1.708-1(b)(1)(iv).

In addition, the capital accounts of all partners must be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in partnership property would be allocated to the partners had there been a taxable disposition of the property for its fair market value. [Treas. Reg. § 1.704-1(b)(2)(iv)(l)] (See PTM 1510, Example 5)

1510 IRC § 754 Elections

IRC § 743: In the case of a transfer of all or part of an interest in a partnership that has a § 754 election in effect, the adjustments to the adjusted tax basis of partnership property under § 743 shall **not** be reflected in the capital account of the transferee partner or on the books of the partnership. In addition, the subsequent adjustments for depreciation, depletion, amortization, and gain or loss with regard to those basis adjustments will be disregarded. [Treas. Reg. §1.704-1(b)(2)(iv)(m)(2)]

IRC § 732: In certain situations where there is a transfer of an interest in a partnership that does not have a § 754 election in effect but the adjusted tax basis of the partnership property is required to be adjusted under § 732(d), such adjustment has **no** effect on the capital accounts of the partners (in the same manner as § 743 basis adjustments). [Treas. Reg. § 1.704-1(b)(2)(iv)(m)(3)]

IRC § 734 - Liquidating Distribution: In the case of a distribution of property in liquidation of a partner's interest in the partnership, and the partnership has a § 754 election in effect, the partner whose interest in the partnership is liquidated and who receives the liquidating distribution shall have a corresponding adjustment to his capital account. However, if the property to which the adjustment relates has already been booked up and the partners' capital accounts have already been adjusted to reflect the book-up, no further adjustment is permitted. [Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4)]

IRC § 734 - Non-liquidating Distribution: In the case of a non-liquidating distribution and the partnership has a § 754 election in effect, the capital accounts of all partners are adjusted to reflect the manner in which the gain or loss would have been allocated had the property been sold by the partnership for its re-computed adjusted basis. [Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4)]

For limitations on the adjustments to capital accounts with regard to the above rules (§§ 743, 732, and 743), see § 1.704-1(b)(iv)(m)(5).

For illustrations, see PTM 1510, Examples 3 & 4.

Example 1*(similar to Example 6695-2): Rafael and Don form a brokerage general partnership for investing and trading in securities. Rafael contributes cash of $10,000 and Don contributes securities of M corporation, which has an adjusted basis of $4,000 and a fair market value of $10,000. The partnership agreement contains all the requirements regarding capital accounts as provided under § 1.704-1(b)(2(iv), including the obligation to restore the negative capital account balance. The partnership agreement also provides that all partnership distribution, income, gain, loss, deduction, and credit will be shared equally between Rafael and Don, except the taxable gain attributable to the pre-contribution appreciation associated with the securities of M corporation will be allocated to Don in accordance with § 704(c). During the first year, the partnership sells the securities of M corporation for $12,000, resulting in taxable gain of $8,000 ($12,000 less $4,000 adjusted tax basis) and a book gain of $2,000 ($12,000 less $10,000 book basis). The partnership has no other income or gain. The gain from the sale of the securities is allocated as follows:*

	Rafael		*Don*	
	Tax	*Book*	*Tax*	*Book*
Cap. acct. upon formation	*$10,000*	*$10,000*	*$4,000*	*$10,000*
Plus: gain	*1,000*	*1,000*	*7,000*	*1,000*
Cap. Acct. at year end	*$11,000*	*$11,000*	*$11,000*	*$11,000*

***Observation**: The book gain of $2,000 allocated equally to Rafael and Don has economic effect. For tax purposes, the taxable gain of $8,000 consists of a built-in gain of $6,000 that is allocated to Don pursuant to § 704(c). The remaining $2,000 gain is allocated equally between Rafael and Don. [See Treas. Reg. § 1.704-1(b)(5) Example (13)(1).]*

***Example 2**: Assume the same facts as in Example 1 except that at the beginning of year 2, the partnership invests $22,000 of cash in the securities of Big Buck Corporation. Five months later, the securities of Big Buck Corporation increase in value to $60,000. Rafael decides to sell one-half of his partnership interest (which is 25% of the interests in the partnership) to Winston for $15,000. The partnership does not elect § 754 during the year of the sale. Based on § 1.704-1(b)(2)(iv)(l) (See* PTM 1500*), Winston inherits 50% of Rafael's capital account balance. Thus, after the sale, Rafael and Winston each have a capital account balance of $5,000 and Don's capital account remains at $11,000. Before the end of the year, the partnership sells the securities for $60,000, which results in a taxable gain of $38,000. The partnership has no other income or loss during the year. Under the partnership agreement, the $38,000 gain is allocated as follows:*

	Rafael	Don	Winston
Cap. Acct. before the sale	*$5,500*	*$11,000*	*$5,000*
Plus gain	*9,500*	*19,000*	*9,500*
Cap. Acct. at year end	*$15,000*	*$15,000*	*$30,000*

The allocation of the $38,000 taxable gain has economic effect. Note that no § 754 is elected by the partnership. Thus, Winston's outside basis (after the sale) is $24,500 (initial cash investment of $15,000 plus distributive share of partnership income of $9,500). However, his inside basis is $15,000 (25% of the partnership total cash of $60,000). [See Treas. Reg. § 1.704-1(b)(5) Example (13)(2).]

***Example 3**: Assume the same facts as in Example 2 except that the partnership has a §754 election in effect for the partnership taxable year in which Rafael sells one-half of his partnership interest to Winston. Accordingly, under § 1.743-1, there is a $9,500 basis increase to the Big Buck corporation securities with respect to Winston. Notwithstanding this basis adjustment, as a result of the sale of the Big Buck corporation securities, Winston's capital account is increased by the $9,500 gain. The fact that Winston does not recognize the gain from such sale due to the § 743 adjustment which increases his basis in the securities by $9,500 for tax purposes is irrelevant for capital accounting purposes since the* *basis adjustment under § 743 is disregarded in the maintenance and computation of the partners' capital account. [See Treas. Reg. § 1.704-1(b)(5) Example (13)(3).] (See* PTM 1510*)*

***Observation**: As explained at* PTM 6700*, the basis adjustment under §§ 732 and 743 as well as the gain on the sale of the securities have no effect on the **book capital account** of Winston. However, Winston's **tax basis capital account** may be adjusted to include $9,500 of the adjusted tax basis adjustment if he so desires, provided that the partnership has a § 754 election in effect. (See* PTM 1310*)*

***Example 4**: Assume the same facts as in Example 3 except that immediately following Rafael's sale of his partnership interest to Winston, the securities of Big Buck Corporation decrease in value to $52,000 and are sold. The $30,000 taxable gain ($52,000 less $22,000 adjusted tax basis) is allocated as follows:*

	Rafael	Don	Winston
Cap. Acct. before the sale	*$5,500*	*$11,000*	*$5,500*
Plus gain	*7,500*	*15,000*	*7,500*
Cap. Acct. at year end	*$13,000*	*$26,000*	*$13,000*

The fact that Winston recognizes $2,000 taxable loss from the sale (due to his $9,500 basis adjustment under § 743) is irrelevant for capital accounting purposes since the basis adjustment under § 743 is disregarded in the maintenance and computation of the partners' capital accounts. [See Treas. Reg. § 1.704-1(b)(5) Example (13)(4).] (See PTM 1310*)*

***Example 5**: Assume the same facts as in Example 2 except that Rafael sells all of his interest in the partnership to Winston for $30,000. Under §708(b)(1)(B), the partnership terminates. Under § 1.708-1(b)(1)(iv), there is a constructive liquidation of the partnership. Immediately before the constructive liquidation, the capital accounts of Don and Winston equal $11,000 each (Winston having inherited Rafael's $11,000 capital account). In accordance with § 1.704-1(b)(2)(iv)(e), the partnership agreement provides that the partners' capital accounts are adjusted to reflect how unrealized taxable gain would have been allocated if the securities had been sold for their $60,000 fair market value. Accordingly, the unrealized gain of $38,000 is credited to the partners' capital accounts as follows:*

	Don	Winston
Cap. acct. following sale	*$11,000*	*$11,000*
Deemed sale Adjustment	*19,000*	*19,000*

Cap. Acct. before constructive liquidation	*\$30,000*	*\$30,000*

The constructive liquidating distribution of the securities is based on their \$60,000 fair market value. Under § 732(b), Don's adjusted tax basis in the constructive distributed securities is \$11,000, which equals his adjusted tax basis in the partnership interest before the constructive liquidation. Winston's basis in the securities is \$30,000, which equals his adjusted tax basis in the partnership interest (he paid Rafael \$30,000 for 50% interest in the partnership). Under § 1.708-1(b)(1)(iv), the partners are treated as contributing the securities to the newly formed partnership. Under § 1.704-1(b)(2)(iv)(d), the capital accounts of Don and Winston in the new partnership are started at \$30,000 each (which is the fair market value of the property constructively contributed to the newly formed partnership by Don and Winston.)

***Observation**: Note that Don's capital account in the newly formed partnership is \$30,000 that reflects the fair market value (or book value) of his share of the partnership property. However, his adjusted tax basis in the partnership interest remains at \$11,000. Before the termination under § 708(b)(1)(B), Don's book-basis capital account equals his tax-basis capital account (\$11,000). However, after the sale of the partnership interest (which causes the § 708(b)(1)(B) termination of the partnership), Don's capital account is adjusted to reflect the fair market value of the property. (A partnership may adjust its partners' capital accounts to reflect the revaluation of its property in other situations such as an admission of a new partner, a retirement of a partner, or an additional contribution of money or property to the partnership, etc.) (See* PTM 1450*). This shows that a partner's capital account (particularly his book capital account) is not an indication of his adjusted basis in the partnership interest.*

***Example 6**: Patricia, John, and Loraine form a general partnership to which each contributes \$10,000. The partnership uses \$10,000 to buy securities of Sub-S Inc. During the next three years, the value of the securities appreciates to \$40,000. The partnership does not engage in any other investment activities. Thus, all of its assets consist of \$20,000 in cash and the securities of the Sub-S Inc. At the end of the third year, Patricia's interest in the partnership is liquidated for \$20,000 cash. The partnership has a § 754 election in effect. As a result of the liquidating distribution to Patricia, the § 754 election requires the partnership to increase its basis in the securities by \$10,000 (the amount Patricia recognizes upon her partnership liquidation: her cost basis is \$10,000 and liquidating distribution is \$20,000.) Under the capital account rules (See* PTM 1510*, item (3)), Patricia's capital account must also be increased by \$10,000 and reduced by the \$20,000 distribution.*

	John		Loraine		Patricia	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Cap. acct. before distribution	*$10,000*	*$10,000*	*$10,000*	*$10,000*	*$10,000*	*$10,000*
Plus: basis adjustment	*0*	*0*	*0*	*0*	*$10,000*	*$10,000*
Less: distribution		*0*		*0*	*(20,000)*	*(20,000)*
Cap. Acct. after liquidation	*$10,000*	*$10,000*	*$10,000*	*$10,000*	*$ 0*	*$ 0*

Note: If Patricia's book capital account had been booked up to $20,000 previously due to some occurrence (e.g., an admission of a new partner), no further adjustment to her capital account would be required at liquidation. Her tax basis capital account, however, is adjusted since the previous book-up does not affect her tax-basis capital account.

1520 Partnership Level Characterization

In general, to be considered as determined and maintained in accordance with the rules of § 704(b) regulations, the adjustments to partners' capital accounts with respect to partnership income, gain, loss and deduction must be made with reference to the Federal tax treatment of such items (and in the case of book items, with reference to the Federal tax treatment of the corresponding tax items) at the partnership level, without regard to any requisite or elective tax treatment of such items at the partner level. [Treas. Reg. § 1.704-1(b)(2)(iv)(n)]

1530 Guaranteed Payments

Guaranteed payments made to a partner for services or the use of capital (under § 707(c)) do not change the recipient partner's capital account except to the extent such payments affect the partnership taxable income resulting from deductions for such payments. [Treas. Reg. § 1.704-1(b)(2)(iv)(o)]

Example: *A owns 50% interest in a partnership. A provides personal services to the partnership and receives a guaranteed payment of $50,000 annually. This guaranteed payment does not affect A's capital account. However, since the partnership is allowed to deduct the payment against its operating income, this deduction affects A's distributive share of partnership income and, as a result, A's capital account (an indirect effect).*

1540 Minor Discrepancies

If there are discrepancies between the partners' actual capital accounts and the capital accounts that would have been had they been determined and maintained in accordance with § 1.704-1(b)(2)(iv), these discrepancies will not adversely affect the validity of an allocation, provided the discrepancies are minor and are attributable to good faith error by the partnership. [Treas. Reg. § 1.704-1(b)(2)(iv)(p)]

1550 Adjustments Where Guidance is Lacking

If the capital account rules of § 1.704-1(b)(2)(iv) fail to provide guidance on how adjustments to the partners' capital accounts should be made in certain situations, those capital account adjustments will be treated as determined and maintained in accordance with the capital account rules if they are made in a manner that:

- maintains equality between the aggregate governing capital accounts of the partners and the amount of the partnership capital reflected on the partnership's balance sheet, as computed for book purposes.
- is consistent with the underlying economic arrangement of the partners, and
- is based, wherever practical, on Federal tax accounting principles. [Treas. Reg. § 1.704-1(b)(2)(iv)(q)]

1560 Restatement of Capital Accounts

If a partnership began operating in a taxable year prior to May 1, 1986 and the capital accounts of the partners, since inception, were not determined and maintained in accordance with the capital account rules under § 1.704-1(2)(b)(iv), such capital accounts will be treated as determined and maintained in accordance with the capital account rules if, for taxable years after April 30, 1986, they meet one of the following two requirements:

1. such capital accounts are (a) adjusted, effective for the first partnership taxable year beginning after April 30, 1986, to reflect the fair market value of partnership property as of the first day of such taxable year and (b) those adjustments are in accordance with the rules of § 1.704-1(2)(b)(iv)(f)(2) & (3) (See PTM 1450 (2) & (3)) or
2. (a) the differences between the partners' actual capital accounts and the capital accounts that would have been had they been determined and maintained in accordance with the capital account rules are not significant (for instance, if the differences are attributable to a failure to provide for the treatment of § 709 expenses (See PTM 1490) or a failure to adjust capital

accounts in accordance with § 754 basis adjustment rule (See PTM 1510)) and (b) the partners' capital accounts are adjusted to bring them into conformity with the capital account rules no later than the end of the first partnership taxable year after April 30, 1986.

The compliance with the above restatement rules have no bearing on the validity of allocations that related to partnership taxable years beginning before May 1, 1986. [Treas. Reg. § 1.704-1(b)(2)(iv)(r)]

1600 ALLOCATION ACCORD*I*NG TO PARTNERS' INTERESTS IN THE PARTNERSHIP

Under the basic allocation rules discussed at PTM 1040, partnership allocations must meet one of the following three requirements:

- The allocation has ***substantial economic effect*** (See PTM 1100),
- The allocation is in accordance with the ***partner's interest in the partnership*** *(*See PTM 1610*)*, or
- The allocation is ***deemed*** to be in accordance with the partner's interest in the partnership under the ***special rules*** (See PTM 1640).

If an allocation does not meet one of the three above requirements, or if a partnership agreement **does not** provide for the allocation of income, gain, loss, deduction, or credit to a partner, then the partnership income, gain, loss, deduction, or credit will be reallocated in accordance with the partners' interest in the partnership. [Treas. Reg. § 1.704-1(b)(1)(i)]

1610 Definition of a Partner's Interest in the Partnership

The partners' interests in the partnership are based on "the manner in which the partners have agreed to **share** the <u>economic benefit or burden</u> (if any) corresponding to the income, gain, loss, deduction, or credit (or items thereof) that is allocated." Except for the partnership items that cannot have economic effect (such as non-recourse deductions of the partnership), the **sharing** arrangement may or may not correspond to the <u>overall</u> economic arrangement of the partners. For instance, a partner who has a 50 percent interest in the partnership may have a 90 percent interest in a particular item of income or deduction. A partner who does not have a deficit make-up obligation unexpectedly receives a downward adjustment to his capital account and the adjustment causes his capital account to be negative. In this case, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner (regardless of his percentage of interest in income or profit) for such year so as to bring that partner's capital account back up to zero (See PTM 1140). [Treas. Reg. § 1.704-1(b)(3)(i)]

1620 Determining a Partner's Interest in a Partnership

The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners. The following factors may be relevant in such determination:

- The partner's relative contribution to the partnership, (See PTM 1620, Example 1)
- The interest of the partner's in economic profits and losses (if different from taxable income or loss),
- The interest of the partners in cash flow and other non-liquidating distributions, and
- The rights of the partners to distributions of capital upon liquidation. [Treas. Reg. § 1.704-1(b)(3)(ii).]

***Example**: Kevin and Michelle contribute $60,000 and $40,000, respectively, to form a partnership. The partnership agreement provides that all income, gain, loss, and deduction will be allocated **equally** between the partners, that the partners' capital accounts will be maintained in accordance with the capital account rules (§1.704-1(2)(b)(iv)), **except** that all partnership distributions will, regardless of the capital account balances, be made 60 percent to Kevin and 40 percent to Michelle and that neither partner is required to restore the deficit capital account balance.*

The (equal) allocations of partnership income, gain, loss, and deduction provided in the partnership agreement have no economic effect (the economic effect test is not met - see PTM 1120*). Since contributions were made in the ratio of 60/40 (factor 1 above), and the partnership agreement provides that all liquidating distributions are to be made in a 60/40 ratio (factor 4 above), partnership income, loss, gain, and deduction will be reallocated 60 percent to Kevin and 40 percent to Michelle.* [*See Treas. Reg. § 1.704-1(b)(5) Example (4)]*

***Observation**: The above four factors are criticized by some tax authors as too general to be of much practical assistance in resolving specific allocation problems.*[8]

1630 Reallocation Rule

In order for a partnership allocation to have economic effect, § 1.704-1(b)(2)(ii)(b) requires that (1) the partners' capital accounts must be maintained in accordance with certain rules (*See* PTM 1300), (2) liquidating distributions must be made in accordance with the partners' positive capital account balances, and (3) the partners with negative capital account balances must be required to restore the deficit balances (*See* PTM 1130) unless the partnership agreement contains a qualified income offset provision (*See* PTM 1140). If only the first two requirements are met and the partnership allocations lack substantial economic effect because of the absence of the third requirement, the portions of the partnership income, gain, loss, or deduction that have no economic effect are reallocated in the following manner:

<u>Step 1</u>: Compute the difference between (a) the proceeds that the partner would receive (or contribution he would be obligated to make) if, immediately at the end of the year to which the allocation in question relates, all partnership property were sold for its book value and the partnership was then liquidated, and (b) the proceeds that the partner would receive (or the contribution he would be obligated to make) if, immediately at the end of the year ***preceding*** the year to which the allocation in question relates, all partnership property were sold for its book value and the partnership was then liquidated.

<u>Step 2</u>: Determine the partner's portion of the allocation that <u>has</u> economic effect and subtract this amount from the amount computed in Step 1. The remainder represents the partner's share of the portion that has no economic effect. [Treas. Reg. § 1.704-1(b)(3)(iii)(b)]

The amounts computed in the first step above must be adjusted for the items described in (4), (5), and (6) of § 1.704-1(b)(2)(ii)(d) (relating to depletion deductions, expected distributions, etc.) (See PTM 1140)

Example: *Steve and Jerry form a general partnership. Each contributes $50,000 that is used by the partnership to buy depreciable personal property for $100,000. The partnership agreement provides that Steve and Jerry will have equal shares of partnership taxable income and loss (computed without regard to cost recovery deductions (i.e., depreciation deductions)) and that* ***all cost recovery deductions will be allocated to Steve****. The agreement further provides that the partners' capital accounts will be maintained in accordance with § 1.704-1(b)(2)(iv), and that distributions in liquidation will be made in accordance with the partners' positive capital account balances throughout the term of the partnership. (****There is no requirement that a partner with a negative capital account has to restore his deficit balance****.) The partnership agreement contains a qualified income offset and that as of the end of each partnership taxable year, the items described in 3(a), (b), and (c) of* PTM 1140 *are not reasonably expected to cause or increase a deficit balance in Steve's capital account.*

In the partnership's first taxable year, it recognizes operating income equal to its operating expenses and has an additional $30,000 cost recovery deduction that is allocated entirely to Steve.

Capital Accounts	***Steve***	***Jerry***
Beginning of the 1st year	*$50,000*	*$50,000*
Less: Cost Recovery Deduction	*(30,000)*	*0*
End of the 1st year	*$20,000*	*$50,000*

In year 2, the partnership recognizes operating income equal to its operating expenses and has a $30,000 cost recovery deduction that is allocated entirely to Steve according to the partnership agreement.

Capital Accounts	***Steve***	***Jerry***
Beginning of the 2nd year	*$20,000*	*$50,000*
Less: Cost Recovery Deduction	*(30,000)*	*0*
End of the 2nd year	*($10,000)*	*$50,000*

The allocation of $30,000 cost recovery deduction to Steve has economic effect up to $20,000. The remaining $10,000 that lacks economic effect must be reallocated according to the above rule:

- *Step 1: If the partnership sold its property at the end of year 2 for $40,000 (its book value and adjusted tax basis: $100,000 cost less depreciation of $60,000 in year 1 and 2), Steve would receive none of the proceeds because his capital account at the end of year 2 is negative. If the partnership sold its property at the end of the year preceding the year the allocation in question relates (which is year 1) for $70,000 (its book value and adjusted tax basis: cost $100,000 less depreciation of $30,000 in year 1), Steve would receive $20,000 based on his positive capital account balance. Thus, the difference between year 1 and 2 is $20,000.*

- *Step 2: Determine the portion that has economic effect: The amount determined in step 1 with regard to Steve is $20,000. Thus, the $30,000 cost recovery deduction allocated to Steve has economic effect up to $20,000. When this amount ($20,000, the portion that has economic effect) is subtracted from the amount determined in step 1 (which is also $20,000), the remainder is zero. This means that with regard to the $10,000 that has to be reallocated, Steve has no interest in it.*

If the above calculation is performed with regard to Jerry, it will show that Jerry has interest in the reallocated $10,000 and this amount is allocated entirely to him.

The above test yields the same result as that of the economic risk of loss test, as illustrated previously in the same example (See PTM 1140*, Example 2): "The allocation of the $30,000 depreciation deduction to Steve* ***satisfies the alternate economic test only to the extent of $20,000****.) Therefore, only $20,000 of the $30,000 allocation has economic effect. The remaining $10,000 must be reallocated in accordance with the partners' interest in the partnership (which is 50/50). However, under the general principle that the partner who is allocated partnership losses must bear the economic risk of loss with regard to the loss, it is necessary to determine who actually bears the economic risk of loss with regard to this $10,000 loss. If the partnership sells the property immediately at the end of the partnership's second taxable year for $40,000 (its adjusted tax basis: total cost of $100,000 less depreciation of $60,000), the entire $40,000 proceeds will be allocated to Jerry pursuant to the partnership agreement (liquidation distribution in accordance to partners' positive capital accounts). Since Jerry's total investment is $50,000 and he receives only $40,000 in the hypothetical liquidation distribution, he bears the economic risk of loss of $10,000. Thus, the remaining $10,000 of the $30,000 cost recovery deduction has to be reallocated to Jerry because he bears the economic burden corresponding to such amount."*

1640 Special Rules

Partnership allocations are respected if:

- the allocations have substantial economic effect (PTM 1100.),
- the allocations are in accordance with the partners' interests in the partnership (PTM 1600.), or
- the allocations are **deemed** to be in accordance with the partners' interests in the partnerships under the **special rules**.

When a property is contributed to the partnership under § 1.704-1(b)(2)(iv)(d) (See PTM 1420), or when the property is re-valued under § 1.704-1(b)(2)(iv)(f)) (See PTM 1450), the property is reflected in the capital accounts of the partners and on the books of the partnership at a book value that differs from its adjusted tax basis (See PTM1460). The depreciation, depletion, amortization, and gain or loss, as computed for book purposes, will be greater or less than the depreciation, depletion, amortization, gain or loss, as computed for tax purposes, with respect to such property. In these cases,

- the capital accounts of the partners are required to be adjusted solely for allocations of **book items** to such partners, as provided under § 1.704(b)(2)(iv)(g) (See PTM 1460), and
- the partner's share of the corresponding tax items are **not** reflected by further adjustments to the partners' capital accounts.

Thus, in order for the allocation of the tax items to be respected for tax purposes, the partners' distributive share of such items must (unless governed by § 704(c)) be determined in accordance with the partners' interests in the partnership. These tax items must be shared among the partners in a manner that takes into account the variation between the adjusted tax basis of such property and its book value (in the same manner as variations between the adjusted tax basis and fair market value of property contributed to the partnership are taken into account in determining the partners' shares of tax items under § 704(c)). [Treas. Reg. § 1.704-1(b)(4)(i)]

For a detailed explanation of the § 704(c) regulations, see PTM 2100.

Other special allocation rules regarding tax credits, excess percentage deductions, and oil and gas property are not discussed in this manual. For allocations attributable to non-recourse liabilities, see PTM 3070.

Example 1: *Dan and Connie form a general partnership to which each contributes $50,000. The partnership uses $100,000 to purchase tangible personal property that it leases out. The partnership agreement provides that the partners' capital accounts will be maintained in accordance with the capital accounts rules, including the obligation to restore deficit capital account balances. In addition, the partnership agreement provides that all income, gain, losses, and deductions of the partnership will be allocated equally between the partners, and all non-liquidating distributions of the partnership will be made equally between the partners. Assume that in each of the partnership's taxable years, its operating income is equal to its operating expense, excluding depreciation deductions and gain or loss on the sale of its property. During the first two years, the partnership has $20,000 of depreciation deductions in each year. These items are allocated equally between Dan and Connie in accordance with the partnership agreement.*[9]

	Dan	***Connie***

Capital account at formation	*$50,000*	*$50,000*
Less: net loss in years 1 & 2	*(20,000)*	*(20,000)*
Capital account at end of year 2	*$30,000*	*$30,000*

***Example 2**: Assume the same facts as in Example 1 except that Peter is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of his admission, the fair market value of the property is $80,000. Peter contributes $40,000 in exchange for an equal one-third interest in the partnership. The capital accounts of Dan and Connie are adjusted upward to $40,000 each as permitted under § 1.704-1(b)(2)(4)(g) (adjustments to reflect book value, see* PTM 1460*). In addition, the partnership agreement is amended to provide that depreciation and gain or loss, as computed for **tax** purposes, with respect to the property, will be shared equally among the three partners in a manner that takes account of the variation between the property's $60,000 adjusted tax basis ($100,000 cost less $40,000 accumulated depreciation) and its $80,000 book value in accordance with § 1.704-1(b)(2)(iv)(f) (revaluation of property, see* PTM 1450*) and the special rule contained in the § 1.704-1(b)(4)(1). Depreciation and gain or loss as computed for **book** purposes, with respect to the property, will be allocated equally among the partners and will be reflected in the partners' capital accounts pursuant to § 1.704-1(b)(2)(iv)(g). Since the requirements of the § 1.704-1(b)(2)(iv)(g) are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with the general maintenance rules provided under § 1.704-1(b)(2)(iv) (see* PTM1300.*)*

***Example 3**: Assuming the same facts as in Example 2 except that immediately after Peter's admission, the property is sold for $80,000, resulting in a taxable gain of $20,000 ($80,000 less $60,000 adjusted tax basis) and no book gain or loss. The partnership is immediately liquidated. Consistent with the special partners' interests in the partnership rule, the partnership agreement provides that the $20,000 gain will be shared by Dan and Connie in accordance with § 704(c) rules. The $120,000 of partnership cash (sales proceeds of $80,000 plus $40,000 contributed by Peter) is distributed equally among the three partners in accordance with their adjusted positive capital account balances, which is $40,000 each.*

	Dan		***Connie***		***Peter***	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Cap. acct. at beg. of yr. 3	*$30,000*	*$40,000*	*$30,000*	*$10,000*	*$40,000*	*$40,000*
Plus: gain	*10,000*		*10,000*	*0*	*0*	*0*
Cap. acct. before liquidation	*$40,000*	*$40,000*	*$40,000*	*$40,000*	*$40,000*	*$40,000*

***Example 4**: Assume the same facts as in Example 3 except that five months after Peter's admission, the property appreciates and is sold for $95,000, resulting in a taxable gain of $35,000 ($95,000 less $60,000 adjusted tax basis) and a book gain of $15,000 ($95,000 less $80,000 book basis). Under the partnership agreement, the book gain of $15,000 is allocated equally among the three partners and the allocation has substantial economic effect.*

	Dan		Connie		Peter	
	Tax	Book	Tax	Book	Tax	Book
Cap. acct. at beg. of yr. 3	$30,000	$40,000	$30,000	$40,000	$40,000	$40,000
Plus: gain	15,000	5,000	15,000	5,000	5,000	5,000
Cap. acct. before liquidation	$45,000	$45,000	$45,000	$45,000	$45,000	$45,000

Consistent with the special partners' interests in the partnership rule) the partnership agreement provides that the $35,000 taxable gain is, in accordance with § 704(c) principles, shared $15,000 to Dan, $15,000 to Connie, and $5,000 to Peter. This ensures that (1) Dan and Connie share equally the $20,000 taxable gain that is attributable to the appreciation in the property that occurs before Peter's admission in the same manner as it was reflected in their capital accounts upon Peter's admission, and (2) Dan, Connie, and Peter share equally the additional $15,000 taxable gain in the same manner as they share the $15,000 book gain.

***Example 5**: Assume the same facts as in Example 2 except that shortly after Peter's admission, the property depreciates and is sold for $74,000, resulting in a taxable gain of $14,000 ($74,000 less $60,000 adjusted tax basis) and a book loss of $6,000 ($74,000 less $80,000 book value). Under the partnership agreement, these items are allocated as follows:*

	Dan		Connie		Peter	
	Tax	Book	Tax	Book	Tax	Book
Cap. acct. at beg. of yr. 3	$30,000	$40,000	$30,000	$40,000	$40,000	$40,000
Plus: gain	7,000	0	7,000	0	0	0
Less: Loss	0	(2,000)	0	(2,000)	0	(2,000)
Cap. acct. before liquidation	$37,000	$38,000	$37,000	$38,000	$40,000	$38,000

The $6,000 book loss is allocated equally among the three partners and such allocation has economic effect. Consistent with the special partners' interests in *the partnership rule () the partnership agreement provides that the $14,000 taxable income is allocated to Dan and Connie pursuant to § 704(c). The fact that Peter bears an economic risk of loss of $2,000 without a corresponding taxable loss is attributable entirely to the "ceiling rule" under § 704(c) (see* PTM 2010.*)*

Assume further that the partnership liquidates immediately after selling the property and distributes the $114,000 cash (sales proceeds of $74,000 plus $40,000 contributed by Peter) equally among the three partners in accordance with their adjusted positive capital account balances, which is $38,000 each. Thus, Dan and Connie each will have $1,000 capital gain (adjusted tax basis in the partnership is $37,000) and Peter will have $2,000 capital loss (adjusted tax basis in the partnership is $40,000) upon partnership liquidation. The $2,000 economic risk of loss that Peter was unable to deduct because of the "ceiling rule" is now deductible.

***Example 6**: Assume the same facts as in Examples 2 except that after Peter's admission to the partnership, the property depreciates and is sold for $54,000, resulting in a $6,000 taxable loss ($54,000 less $60,000 adjusted tax basis) and a book loss of $26,000 ($54,000 less $80,000 book value). The book loss is allocated equally among the partners ($8,666 each) and has substantial economic effect. Consistent with the special partners' interests in the partnership rule) the partnership agreement provides that the entire $6,000 taxable loss is, in accordance with § 704(c) principles, included in Peter's distributive share.*

	Dan		Connie		Peter	
	Tax	Book	Tax	Book	Tax	Book
Cap. acct. at beg. of yr. 3	$30,000	$40,000	$30,000	$40,000	$40,000	$40,000
Less: Loss	0	(8,666)	0	(8,666)	(6,000)	(8,667)
Cap. acct. before liquidation	$30,000	$31,334	$30,000	$31,334	$34,000	$31,333

***Example 7**: Assume the same facts as in Example 2 except that the partnership has an additional $20,000 depreciation deduction for tax and $26,667 book depreciation attributable to the property. The $26,667 book depreciation deduction is allocated equally among the three partners, and that allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule the partnership agreement provides that the entire $20,000 cost recovery deduction for the partnership third taxable year is allocated to Peter. This is because under the § 704 regulations, Peter is required to include the cost recovery deduction for such property in his distributive share up to the amount of*

the book depreciation deduction for such property allocated to him. (See ¶ 2010) for detailed explanations of § 704(c))

	Dan		Connie		Peter	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Cap. acct. at beg. of yr. 3	*$30,000*	*$40,000*	*$30,000*	*$40,000*	*$40,000*	*$40,000*
Less: depreciation in yr.3	*0*	*(8,889)*		*(8,889)*	*(20,000)*	*(8,889)*
Cap. acct. before liquidation	*$30,000*	*$31,334*	*$30,000*	*$31,334*	*$20,000*	*$31,333*

1650 Amendment to Partnership Agreement

If an allocation has substantial economic effect or is deemed to be made in accordance with the partners' interests in the partnership based on the partnership agreement that is effective for the taxable year to which such allocation relates, and such partnership agreement thereafter is modified, both the tax consequences of the modification and the facts and circumstances surrounding the modification will be closely scrutinized to determine whether the purported modification was part of the original agreement.

If it is determined that the purported modification was part of the original agreement, prior allocations may be reallocated in a manner consistent with the modified terms of the agreement, and subsequent allocations may be reallocated to take account of such modified terms. For example, if a partner is obligated by the partnership (original) agreement to restore the deficit balance in his capital account and thereafter, such obligation is eliminated, reduced (other than as provided in § 1.704-1(b)(2)(ii)(f)), or is not complied with in a timely manner, such elimination, reduction, or noncompliance may be treated as if **it always were part of the partnership agreement** for purposes of making any reallocations and determine the appropriate limitations period. [Treas. Reg. § 1.704-1(b)(4)(iv)]

2000 CAPITAL ACCOUNTS- ALLOCATIONS WITH RESPECT TO CONTRIBUTED PROPERTY

Under the general principle of § 704(b) and (c), an allocation of partnership's income, gain, loss, or deductions must have substantial economic effect, or be in accordance with the partners' interests in the partnership. (See PTM 1040)

When property is contributed to a partnership, the contributing partner must be allocated certain items of income, gain, loss and deductions attributable to the pre-contribution appreciation or depreciation. (See PTM 2100)

If the contributed property is distributed by the partnership to a non-contributing partner, the contributing partners may recognize certain gain or loss. (See PTM 2450)

If the contributing partner receives certain distributions from the partnership, he may have to recognize gain.

2100 GENERAL PRINCIPLES

The purpose of § 704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution (built-in) gain or loss. To achieve that purpose, § 704(c) and the regulations thereunder provide the following: [Treas. Reg. § 1.704-3(a)(1)]

- A partnership's allocation of income, gain, loss, and deduction with respect to property contributed by a partner to the partnership must take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution.
- The allocation must be based on a **reasonable** method that is consistent with the purpose of § 704(c). A reasonable allocation method must include the application of all of the rules of § 704(c) regulations (e.g., aggregation rules).
- Section 704(c) regulations provide three allocation methods that are generally reasonable: Traditional method, Traditional method with curative allocations, and Remedial allocation method. Other methods may be reasonable in appropriate circumstances.
- An allocation method is not necessarily unreasonable merely because another method would result in a higher aggregate tax liability. However, in the absence of specific published guidance, an allocation method that distorts the basis of the contributed property or disregards the effects on the book capital accounts is not reasonable.

2110 Operating Rules

The allocation method applies on a property-by-property basis.

In determining if there is a disparity between the adjusted tax basis and the fair market value, the built-in gains and built-in losses on items of contributed property cannot be aggregated.

A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purposes of § 704(c).

It may be unreasonable to use one method for appreciated property and another method for depreciated property.

It may be unreasonable to use the traditional method for built-in gain property contributed by a partner with a high marginal tax rate while using the curative allocations for built-in gain property contributed by a partner with a low marginal tax rate. [Treas. Reg. § 1.704-3(a)(2).]

2120 Definitions of § 704(c) Property

A § 704(c) property is a property that at the time of contribution, its book value (i.e., fair market value) differs from the contributing partner's adjusted tax basis.

For purposes of IRC § 704(c), book value is determined as contemplated by § 1.704-1(b). Thus, book value is equal to fair market value (See PTM 1470) determined at the time of contribution and is subsequently adjusted for cost recovery (depreciation) and other events that affect the basis of the property.

For a partnership that maintains capital accounts in accordance with the capital account rules under § 1.704-1(b)(2)(iv) (See PTM 1400), the book value of property is initially the value used in determining the contributing partner's capital account under § 1.704-1(b)(2)(iv)(d) (regarding contributed property, see PTM 1420) and is appropriately adjusted thereafter (e.g., for book cost recovery under §§ 1.704-1(b)(2)(iv)(g)(3) and 1.704-3(d)(2) and other events that affect the basis of the property).

For a partnership that does not maintain capital accounts under the rules of § 1.704-1(b)(2)(iv), it must comply with treasury regulation section 1.704-3 by using a book capital account based on the same principle stated immediately above

If the partnership has a termination under § 708(b)(1)(B) [10], the property deemed to be contributed to the new partnership is not a § 704(c) property unless the property was already a § 704(c) property in the hands of the terminated partnership. This provision applies to termination under § 708(b)(1)(B) occurring on or after May 9, 1997. However, for terminations that occurred prior to May 9, 1997, the provision may be applied provided that the partnership and its partners apply the provision in a consistent manner. [Treas. Reg. § 1.704-3(a)(3)(i)]

2130 Definitions of Built-in Gain and Built-in Loss

The built-in gain on § 704(c) property is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution.

The built-in gain is thereafter reduced by the decreases in the difference between the property's book value and adjusted tax basis.

The built-in loss on § 704(c) property is the excess of the contributing partner's adjusted tax basis over the property's book value upon contribution.

The built-in loss is thereafter reduced by the decreases in the difference between the property's book value and adjusted tax basis. [Treas. Reg. § 1.704-3(a)(3)(ii)]

For definition of book value, see PTM 2120.

2140 Accounts Payable

If a partner using a cash receipts and disbursements accounting method contributes accounts payable and other accrued but unpaid items, these items are treated as § 704(c) property for purposes of applying the rules of Treas. Reg. § 1.704-3.

2150 Other Provisions

The rules of IRC § 704(c) and the regulations thereunder apply to a contribution of property to the partnership only if the contribution is governed by § 721, taking into account other provisions of the code. Thus, if a transfer of property to a partnership is treated as a sale under § 707, the property is not a § 704(c) property. [Treas. Reg. § 1.704-3(a)(5)]

2160 Revaluation and § 704(c) Principles

- The principles of § 704(c) apply to allocations with respect to property for which its book value differs from its adjusted tax basis as a result of the partnership's revaluation (See PTM 1450) of its property under § 1.704-1(b)(2)(iv)(f) (reverse § 704(c) allocations).

- Partnerships are not required to use the same allocation method for reverse § 704(c) allocations as for contributed property, even if at the time of revaluation, the property is already subject to the § 704(c) regulations. Thus, if the partnership uses an allocation method for a contributed property, it can use another allocation method for such property after a revaluation. In addition, each time the partnership evaluates its property, it may use a different allocation method, provided the method used is reasonable and consistent with the purposes of § 704(b) and (c).

- A partnership making adjustments under § 1.743-1(b) or § 1.751-1(a)(2) must account for built-in gain and loss under § 704(c) in accordance with the principles of the § 704(c) regulations. [Treas. Reg. § 1.704-3(a)(6)] (§1.743-(1)(b) relates to adjustments to basis of partnership property as a result of a transfer of an interest in the partnership. Treas. Reg. § 1.751-1(a)(2) relates to adjustments to IRC § 751 property (hot assets) due to a sale or exchange of an interest in the partnership.)

2170 Transfer of Partnership Interest

If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. [Treas. Reg. § 1.704-3(a)(7)]

If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner. [Treas. Reg. § 1.704-3(a)(7)]

2180 Disposition of Property in Non-recognition Transaction

If a partnership disposes of § 704(c) property in a non-recognition transaction in which no gain or loss is recognized, the substituted basis property is treated as IRC § 704(c) property with the same amount of built-in gain or loss as the § 704(c) property disposed of by the partnership. IRC § 7701(a)(42) defines “substituted basis property” as property whose basis is determined by reference to the basis in the hands of the donor, grantor, or other transferor.

If gain or loss is recognized in a non-recognition transaction, appropriate adjustments must be made. The allocation method for the substituted basis property must be consistent with the allocation method chosen for the original property.

If a partnership transfers § 704(c) property together with other property to a corporation under § 351 (nontaxable transfer to a corporation controlled by transferor), in order to preserve the § 704(c) property's built-in gain or loss, the basis in the stock received in exchange for § 704(c) property is determined as if the § 704(c) property had been the only property transferred to the corporation by the partnership. [Treas. Reg. § 1.704-3(a)(8)]

2190 Tiered Partnerships

If a partnership contributes § 704(c) property to another partnership (lower-tier partnership), or if a partner who contributes § 704(c) property to a partnership contributes his partnership interest to another partnership (the upper-tier partnership), the upper-tier partnership must allocate its distributive share of the lower-tier partnership items with respect to that § 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss. [Treas. Reg. § 1.704-3(a)(9)]

2195 Anti-Abuse Rules

An allocation method (or a combination of methods) is not reasonable if the contribution of property (or event that results in reverse § 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. [Treas. Reg. § 1.704-3(a)(10)]

If an allocation method prescribed under § 704(c) regulations (e.g., traditional method) causes a shift in the tax consequences of the built-in gain or loss, such method will not be respected. See PTM 2210, Example (4).

2200 TRADITIONAL METHOD

Under the general principle of allocation under § 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. Section 704(c) regulations provide three allocation methods that are generally reasonable: Traditional method, Traditional method with curative allocations (See PTM 2220), and Remedial allocation method (See PTM 2400).

In general, the traditional method requires that the partnership's income, gain, loss, or deductions attributable to § 704(c) property must be allocated in a manner to avoid shifting the tax consequences of the built-in gain or loss. Under this rule:

- If the partnership sells § 704(c) property and recognizes gain or loss, built-in gain or loss on the property is allocated to the contributing partner.
- If the partnership sells a portion of, or an interest in, § 704(c) property, a proportionate part of the built-in gain or loss is allocated to the contributing partner.
- If the § 704(c) property is subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items must take into account the built-in gain or loss on the property. For example, the <u>tax allocation of cost recovery deductions with respect to § 704(c) property to non-contributing partners must, to the extent possible, equal the book allocations to those partners</u>. There is a limitation to this requirement under the Ceiling Rules discussed at PTM 2210. [Treas. Reg. § 1.704-3(b)(1)]

See Examples at PTM 2210.
PTM 2210 The "Ceiling Rule" Under Traditional Method
PTM 2220 Traditional Method with Curative Allocation
PTM 2230 Reasonable Curative Allocations

2210 The "Ceiling Rule" Under Traditional Method

The total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the partnership total income, gain, loss, or deduction with respect to that property for the taxable year. [Treas. Reg. § 1.704-3(b)(1).]

***Example 1**: Terry and J.J form a partnership and agree that all partnership's items will be shared equally except that items attributable to § 704(c) property will be allocated under the traditional method. Terry contributes depreciable property with an adjusted tax basis of $4,000 and a fair market value of $10,000. J.J. contributes $10,000 cash. Under § 1.704-3(a)(3)* (See PTM 2130)*, the built-in gain is $6,000.*

The property is depreciated using the straight-line method over a 10-year recovery period. Thus, the annual tax depreciation on the property is $400 and the book depreciation is $1,000. If the adjusted tax basis of the property equaled its fair market value at the time of contribution (i.e., $10,000), J.J would have been entitled to a depreciation of $500 annually for both book and tax purposes (50% of total $1,000 depreciation). Under the "ceiling rule", the partnership can allocate only $400 of tax depreciation and the tax allocation must be allocated entirely to J.J.

Assuming during the first year, the partnership operating income equals its expenses (without depreciation), the book value of the property at the end of the first year is $9,000 and its adjusted tax basis is $3,600. The capital accounts of the partners are:

	Terry		***J.J.***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Less: Losses	*500*	*0*	*500*	*400*
End of year 1	*$9,500*	*$4,000*	*$9,500*	*$9,600*

Also, Terry's built-in gain with respect to the property decreases to $5,400 ($9,000 book value less $3,600 adjusted tax basis). [See Treas. Reg. § 1.704-3(b)(2), Ex. (1)(ii).]

***Example 2**: Assume the same facts as in Example 1 except the partnership sells the property at the beginning of year 2 for $9,000. The partnership realizes a taxable gain of $5,400 ($9,000, the amount realized less $3,600 adjusted tax basis). Under § 1.704-3(b)(1), the entire gain of $5,400 must be allocated to Terry because the property he contributed has that much built-in gain remaining. If the property is sold for less than $9,000, the gain will be less than $5,400 and has to be allocated entirely to Terry.*

Assume the partnership sells the property at the beginning of year 2 for $10,000, the partnership realizes a taxable gain of $6,400. Under § 1.704-3(b)(1), only $5,400 of the gain has to be allocated to Terry to account for his built-in gain.

The remaining $1,000 of the gain is allocated equally between Terry and J.J. in accordance with the partnership agreement. [*See Treas. Reg. § 1.704-3(b)(2), Ex. (1)(iii).]*

Example 3*: Assume the same facts as in Example 1 except that at the beginning of year 2, the partnership sells the property for $9,000 and allocates the entire $5,400 gain to Terry. Thereafter, the partnership liquidates and distributes its assets ($19,000) to Terry and J.J. in proportion to their* ***book*** *capital account balances. Their capital accounts are as follows:*

	Terry		***J.J.***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Less: Losses	*500*	*0*	*500*	*400*
End of year 1	*$9,500*	*$4,000*	*$9,500*	*$9,600*
Add: Income in year 2	*0*	*5,400*	*0*	*0*
End of year 2	*$9,500*	*$9,400*	*$9,500*	*$9,600*

Terry and J.J each receive a distribution of $9,500 in proportion to their ***book*** *capital account balances. Thus, Terry will recognize a capital gain of $100 ($9,500, the amount distributed to Terry, less $9,400, his adjusted tax basis which is equal to his tax-basis capital account). J.J. recognizes a capital loss of $100 (because his adjusted tax basis of $9,600 exceeds the distribution of $9,500). [See Treas. Reg. § 1.704-3(b)(2), Ex. (1)(iv).]*

Example 4*: (Unreasonable use of the traditional method)*

*Bob and Marion form a partnership and agree that all partnership items will be allocated equally between themselves except the items attributable to § 704(c) property will be allocated using the traditional method. Bob contributes equipment with an adjusted tax basis of $1,000 and a book value of $10,000. The equipment has only one year remaining on its cost recovery schedule although its remaining economic life is substantially longer. The equipment is a § 704(c) property and the built-in gain at the time of contribution is $9,000. Marion contributes $10,000 cash. Marion has a large unused net operating loss carryover, which will expire soon. Under § 1.704-1(b)(2)(iv)(g)(3) (*See PTM 1460*), the partnership must allocate the entire book depreciation to the partners in year 1. Thus, in the partnership's first year, there is a book depreciation of $10,000 and a tax depreciation of $1,000. At the beginning of year 2, the partnership sells the property for $10,000 and recognizes a gain of $10,000 (adjusted tax basis after the first year depreciation is zero).*

The method used by the partnership is unreasonable for the following reasons:

- *At the beginning of year 2, both the book value and adjusted tax basis of the equipment are $0 (due to book and tax depreciation in year 1). Therefore, there is no remaining built-in gain ($0 book value less $0 tax basis). The gain of $10,000 is allocated equally to Bob and Marion. Thus, Marion is allocated $1,000 tax depreciation in year 1 and $5,000 gain in year 2, which results in a net gain of $4,000. The interaction of the partnership's one-year write-off of the entire book value of the equipment and the use of the traditional method result in a shift of $4,000 of the pre-contribution gain in the equipment to Marion.*
- *Under the anti-abuse rule (*See PTM 2100*), the traditional method is not reasonable because it shifts a significant amount of taxable income to a partner with a low marginal tax rate (Marion has unused net operating loss carryover) and from a partner with a high marginal tax rate.*
- *Under these facts, if the partnership agreement in effect for the year of contribution had provided that tax gain from the sale of the property (if any) would always be allocated to Bob to offset the effect of the ceiling rule limitation, the allocation method would not violate the anti-abuse rule stated above. [See Treas. Reg. § 1.704-3(b)(2), Ex. (2)(ii).]*
- *See Example 3 at* (PTM 2230) *for methods that could be used to correct the distortion caused by the ceiling rule.*

2220 Traditional Method with Curative Allocation

The interaction between the traditional method and the ceiling rule may cause distortions to the tax consequences in certain situations (See PTM 2210, Example 4). To correct such distortions, a partnership using the traditional method may make a reasonable curative allocation to reduce or eliminate disparities between book and tax items of noncontributing partners.

A curative allocation is an allocation of the partnership's income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item. For example, if a non-contributing partner is allocated less tax depreciation than book depreciation with respect to an item of § 704(c) property, the partnership may make a curative allocation to that partner by allocating tax depreciation from another item of partnership property to make up the difference (although the corresponding book depreciation of that other item is still allocated to the contributing partner.) [Treas. Reg. § 1.704-3(c)(1)]

A partnership's curative allocations may be limited to certain specific property even if the allocations of these items do not fully offset the effect of the ceiling rule. [Treas. Reg. § 1.704-3(c)(1)]

A partnership must be consistent in its application of curative allocations with respect to each item of § 704(c) property from year to year. [Treas. Reg. § 1.704-3(c)(2)]

2230 Reasonable Curative Allocations

The amount, the timing, and the type of curative allocations must be reasonable:

<u>Amount</u>: If a curative allocation exceeds the amount necessary to offset the effect of the ceiling rule (in the current year or prior years), the excess allocation is not reasonable. [Treas. Reg. § 1.704-3(c)(3)(1)]

<u>Timing</u>: The period of time over which the curative allocations are made is a factor in determining if the allocations are reasonable. Curative allocations may be made in the current year to offset the effect of the ceiling rule in prior years, provided that the current year curative allocations <u>must be made over a reasonable period of time</u> and are provided for under the partnership agreement. [Treas. Reg. § 1.704-3(c)(3)(ii)]

<u>Type</u>: To be reasonable, a curative allocation of income, gain, loss, or deduction must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule. The expectation must exist at the time the § 704(c) property is contributed to the partnership and the allocations with respect to that property become part of the partnership agreement. If the partnership agreement is not sufficiently specific with regard to the manner in which allocations of the § 704(c) property are to be made, the expectation is to be tested at the time the allocations are actually made. [Treas. Reg. § 1.704-3(c)(3)(iii)]

***Example 1**: Lisa and Paul form partnership LP, agreeing that they will share all partnership's items equally, except that allocations attributable to § 704(c) property will be made under the traditional method with curative allocations. Lisa contributes equipment with an adjusted tax basis of $4,000 and a book value of $10,000. The property has 10 years on its cost recovery schedule and is depreciable using the straight-line method. Paul contributes $10,000 cash, which was used to buy inventory for resale.*

In the first year, the revenue generated by the equipment equals its expenses, excluding the cost recovery deduction, which is $1,000 for book and $400 for tax. The inventory is sold during the year for $10,700, generating taxable income of $700. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from the equipment. Under the traditional method, Lisa and Paul would each be allocated $350 of income from the inventory sale for book and tax purposes and $500 of book depreciation on the equipment. The tax depreciation would be allocated entirely to Paul, the noncontributing partner. Thus, at the end of the first year, Lisa's and Paul's book and tax capital accounts would be as follows:

	Lisa		***Paul***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Less: depreciation	*(500)*	*0*	*(500)*	*(400)*
Sales Income	*350*	*350*	*350*	*350*
End of year 1	*$9,850*	*$4,350*	*$9,850*	*$9,950*

Due to the ceiling rule (i.e., allocation of tax depreciation to Paul is limited to the total partnership depreciation during the year, which is $400), there is a $100 disparity between Paul's book and tax capital accounts. Under the curative allocation method, the partnership may allocate an additional $100 of income from the inventory sale to Lisa (the contributing partner) for tax purposes. As a result, Paul's income is reduced by $100 which has the same tax effect as an allocation of $100 of tax deduction to Paul. This curative allocation results in the following capital accounts:

	Lisa		***Paul***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Less: depreciation	*(500)*	*0*	*(500)*	*(400)*
Sales Income	*350*	*450*	*350*	*250*
End of year 1	*$9,850*	*$4,450*	*$9,850*	*$9,850*

The above curative allocation is reasonable because it "cures" the disparity in Paul's capital account caused by the ceiling rule. (Note that for book purposes, the sales income is allocated equally between Lisa and Paul). However, if the partnership allocates the entire $700 of sales income to Lisa, such allocation is unreasonable since the allocation exceeds the amount necessary to offset the disparity caused by the ceiling rule. [See Treas. Reg. § 1.704-3(c)(4), Ex. (1).]

***Example 2**: Joe and Elaine form a partnership, agreeing that they will share all partnership items equally, except that allocations attributable to § 704(c) property will be made under the traditional method with curative allocations, but only to the extent the partnership has sufficient tax depreciation. Joe contributes property J with an adjusted tax basis of $3,000 and a book value of $10,000. Elaine contributes property E with an adjusted tax basis of $6,000 and a book value of $10,000. Both property have 5 years remaining on their cost recovery life and are depreciable using the straight-line method. Since both property J and E have built-in gains of $7,000 and $4,000, respectively, they are § 704(c) property. Each property generates $500 of operating income. The book depreciation of each property for each of five years is $2,000. The tax depreciation for each of five years is $600 for property J and $1,200 for property E. Under the traditional method, the partnership items are allocated as follows:*

	Joe		**Elaine**	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$3,000*	*$10,000*	*$6,000*
Prop. J depreciation	*(1,000)*	*0*	*(1,000)*	*(600)*
Prop. E depreciation	*(1,000)*	*(1,000)*	*(1,000)*	*(200)*
Operating income	*500*	*500*	*500*	*500*
End of year 1	*$8,500*	*$2,500*	*$8,500*	*$5,700*

*Note that the allocation of tax depreciation on property E to Joe is to the extent of his share of book depreciation ($1,000) as required under the traditional method. (*See PTM 2200*). The tax allocation of the property J to Elaine is limited to $600 under the ceiling rule.*

Under the traditional method, Joe is allocated more tax depreciation deductions than Elaine, even though Elaine contributes property with a smaller disparity reflected on the partnership's book and tax capital accounts. The partnership may make curative allocations to Elaine of an additional $400 of tax deductions each year which reduces the disparity between Joe's and Elaine's book and tax capital accounts ratably each year.

	Joe		**Elaine**	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$3,000*	*$10,000*	*$6,000*
Prop. J depreciation	*(1,000)*	*0*	*(1,000)*	*(600)*
Prop. E depreciation	*(1,000)*	*(600)*	*(1,000)*	*(600)*
Operating income	*500*	*500*	*500*	*500*
End of year 1	*$8,500*	*$2,900*	*$8,500*	*$5,300*

The above allocations are reasonable provided the allocations meet other requirements provided under § 704(c) regulations. [See Treas. Reg. § 1.704-3(c)(4), Ex. (2).]

***Example 3**: Read Example 4 at* PTM 2210*. The allocation under the traditional method in this example is unreasonable since it shifts the tax consequences of the built-in gain to the partner with a low marginal tax rate.*

Assume the partnership has sales income of $8,000 in the first year. Pursuant to the partnership agreement, the sales income is allocated equally between Bob and Marion. Their capital accounts are as follows:

	Bob		***Marion***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$1,000*	*$10,000*	*$10,000*
Less: depreciation	*(5,000)*	*0*	*(5,000)*	*(1,000)*
Sales Income	*4,000*	*4,000*	*4,000*	*4,000*
End of year 1	*$9,000*	*$5,000*	*$9,000*	*$13,000*

To correct the disparity caused by the ceiling rule, the partnership may allocate some of the sales income to Bob. If the partnership allocates the entire $8,000 of sales income to Bob in the first year, such curative allocation is not reasonable because it is done within a period of time significantly shorter than the economic life of the property. Thus, assuming the remaining economic life of the property is 10 years, the partnership, instead of allocating the entire additional $4,000 of sales income to Bob, may allocate 10 percent or $400 in the first year to Bob. This curative allocation is reasonable. [See Treas. Reg. § 1.704-3(c)(4), Ex. (3).]

2300 RESERVED

2400 REMEDIAL ALLOCATION METHOD

To eliminate the distortion caused by the ceiling rule, a partnership may adopt the remedial allocation method by creating remedial items and allocating these items to the partners.

Under the remedial allocation method, the partnership first determines the amount of book items (explained at PTM 2410) and the partners' distributive share of these items under § 704(b).

The partnership then allocates the corresponding tax items recognized by the partnership, if any, using the traditional method (described at PTM 2200). If the ceiling rule (described at PTM 2210) causes the book allocation of an item to differ from the corresponding tax allocation of the same item to the non-contributing partner, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the non-contributing partner.

The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner. [Treas. Reg. § 1.704-3(d)(1)]

See Example at PTM 2440

2410 Determining the Amount of Book Items

The determination of the amount of book items for the purpose of the remedial allocation method is done in the following manner: the book basis of the contributed property is divided into two portions. The portion equal to the adjusted tax basis in the property is depreciated in the same manner as the adjusted tax basis in the property is depreciated (i.e., generally over the remaining recovery period under § 168(i)(7) or other applicable sections.) The portion of the book basis in excess of the adjusted tax basis is recovered using any depreciation period and method available to the partnership for newly purchased property. [Treas. Reg. § 1.704-3(d)(2)]

Note that the above determination of the amount of book item for the purpose of the remedial allocation method is different from the determination of book items for purposes of § 704(b) provided under § 1.704-1(b)(2)(iv)(g)(3)) (See PTM 1460)

2420 Character of Remedial Allocations

The character of the remedial allocations of income, gain, loss, or deductions to the non-contributing partner is determined with reference to the items limited by the ceiling rule. (see 2210 for ceiling rule)

The same principle applies to the offsetting remedial allocations

Any partner level tax attributes are determined at the partner level.

For example, if the ceiling-rule limited item is depreciation from property used in a rental activity, the remedial allocation to the non-contributing partner is depreciation from property used in a rental activity and the offsetting remedial allocation to the contributing partner is ordinary income from that rental activity. Each partner then applies § 469 to the allocation at his level as appropriate. [Treas. Reg. § 1.704-3(d)(3)]

See Examples at PTM 2440

2430 Effect of the Remedial Items

Effect on Partnership: Remedial items do not affect the partnership's computation of its taxable income under § 703 and do not affect the partnership's adjusted tax basis in its property.

Effect on Partners: Remedial items are notional tax items created by the partnership solely for tax purposes and do not affect the partners' book capital accounts. Remedial items have the same effect as actual tax items on a partner's tax liability and on the partner's adjusted tax basis in the partnership interest. For example, if the remedial item is $500 of partnership taxable gain on sale of a partnership property allocated to partner A, the allocation affects A's tax liability in the year of allocation and his adjusted tax basis in the partnership interest. [Treas. Reg. § 1.704-3(d)(4)]

2440 Limitations on Remedial Allocation Method

Limitation on Taxpayer: in the absence of published guidance, the remedial allocation method is the only reasonable § 704(c) method allowing the creation of notional tax items. In other words, if a partnership uses another method to create a notional tax item, such method is unreasonable.

Limitation on the Internal Revenue Service (IRS): In exercising its authority under § 1.704-3(a)(10) (Anti-abuse rules, see PTM 2100) to make adjustments if a partnership's allocation method is unreasonable, the IRS may not require a partnership to use the remedial method or any other method involving the creation of notional tax items. [Treas. Reg. § 1.704-3(d)(5)]

***Example**: Karen and Steve form a partnership and agree that each will be allocated a 50 percent share of all partnership items, except that items attributable to § 704 property will be allocated the remedial allocation method and that the straight-line method will be used to recover excess book basis. Karen contributes depreciable property with an adjusted tax basis of $4,000 and a fair market value of $10,000. The property has 10 years remaining on its economic life and 4 years remaining on its tax recovery period. Steve contributes $10,000 cash which is used by the partnership to purchase land. The partnership's operating income equals its operating expenses, except for depreciation deductions.*

In years 1 through year 4, under the remedial allocation method, the book depreciation is computed as follows: the total book basis of $10,000 is divided into two portions. The portion equal to the adjusted tax basis of the property ($4,000) is depreciated over its remaining tax recovery period (i.e., 4 years). Thus, the annual book depreciation for this portion is $1,000 ($4,000 ÷ 4). The book portion in excess of the adjusted tax basis (i.e., $6,000) is depreciated over its remaining economic life (10 years). Thus, the annual book depreciation for this portion is $600 ($6,000 ÷ 10). Therefore, from year 1 through year 4, total book depreciation is $1,600 ($1,000 + 600). Under the partnership agreement, Karen and Steve are each allocated 50 percent of the book allocation or $800. The tax depreciation of the property is $1,000 ($4,000 adjusted tax basis over 4 years). Thus, under the general requirement of § 704(c), Steve, the non-contributing partner, will be allocated tax depreciation equivalent to his share of the book depreciation ($800). The remaining $200 of tax depreciation is allocated to Karen, the contributing partner. No remedial allocation is made in the first 4 years because the ceiling rule does not cause a disparity between book and tax depreciation with regard to Steve. Their capital accounts at the end of year 4 are as follows:

	Karen		***Steve***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*

Less: depreciation	*(3,200)*	*(800)*	*(3,200)*	*(3,200)*
End of year 1	*$6,800*	*$3,200*	*$6,800*	*$6,800*

In each of years 5 through 10, the partnership has $600 of book depreciation (computed above) and no tax depreciation. Under the partnership agreement, Karen and Steve are each allocated $300. Thus, there is disparity in Steve's book and tax depreciation because he has $300 book depreciation but no tax depreciation under the ceiling rule. The partnership must make remedial allocation of <u>$300 of tax depreciation</u> deduction to Steve for each of the years from 5 through 10 and simultaneously make an offsetting remedial allocation of <u>$300 taxable income</u> to Karen for those years. The character of the $300 taxable income allocated to Karen must be the same as the income generated by the property. Their capital accounts at the end of year 5 are as follows:

	Karen		***Steve***	
	Book	*Tax*	*Book*	*Tax*
Initial contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Less: Depreciation	*(3,200)*	*(800)*	*(3,200)*	*(3,200)*
End of year 4	*$6,800*	*$3,200*	*$6,800*	*$6,800*
Year 5 depreciation	*(300)*	*0*	*(300)*	*0*
Remedial allocation	*0*	*300*	*0*	*(300)*
End of year 5	*$6,500*	*$3,500*	*$6,500*	*$6,500*
Years 5 - 10 depreciation	*(1,500)*	*0*	*(1,500)*	*0*
Years 5-10 Rem. Alloc.	*0*	*1,500*	*0*	*(1,500)*
End of Year 10	*$5,000*	*$5,000*	*$5,000*	*$5,000*

Under the remedial allocation method, the partners' book and tax capital accounts will be equal at the end of the economic life of the contributed property. [See Treas. Reg. § 1.704-3(d)(7), Ex. (1).

For illustration of remedial allocation on sale of the property, see Treas. Reg. § 1.704-3(d)(7), Ex. (2).

For an illustration of a remedial allocation involving built-in gain property, sold for a book and tax loss, see Treas. Reg. § 1.704-3(d)(7), Ex. (3).

2450 Exceptions and Special Rules

Small Disparity: if the difference between the fair market value and the adjusted tax basis of a contributed property is small, the partnership may:

- Use a reasonable § 704(c) method;
- Disregard the application of § 704(c) to the property; or

- Defer the application of § 704(c) to the property until the disposition of the property.

Definition of small disparity: The disparity is less than 15 percent of the adjusted tax basis of all properties contributed, and the total gross disparity is less than $20,000.

Aggregation Rules: If contributed by one partner during the partnership taxable year, each of the following types of property may be aggregated for the purposes of making § 704(c) allocations:

- Depreciable property: All property, other than real property, that is included in the same general asset account of the contributing partner and the partnership under § 168.

- Zero Basis Property: All property, other than real property, with a basis equal to zero.

- Inventory: If the partnership does not use a specific method of accounting, each item of inventory, other than qualified financial assets (see statement below).

There are special rules for securities partnerships provided under § 1.704-3(e)(3) which are not discussed in this manual.

2500 DISTRIBUTION OF CONTRIBUTED PROPERTY

The Seven-year Recognition Rule: If a partnership distributes § 704(c) property to a partner **within 7 years** (See PTM 2600) from the date the property was contributed to the partnership, the contributing partner has to recognize gain or loss in an amount equal to the gain or loss that would have been allocated to such partner under § 704(c)(1)(A) and § 1.704-3 if the distributed property had been sold by the partnership to the receiving partner for its fair market value at the time of distribution. [Treas. Reg. § 1.704-4(a)(1)]

The Five-year Recognition Period: If a property was contributed prior to June 9, 1997, the recognition period is five years. (See PTM 2510)

The above rule applies only to the extent the distribution by the partnership is a distribution to a partner acting in his capacity of a partner (i.e., a distribution within the meaning of § 731). [Treas. Reg. § 1.704-4(a)(2)]

For definition of § 704(c) property, see PTM 2120

Example 1*: On January 1, 1994, Phyllis, Ron, and Renee form a partnership. Phyllis contributes $10,000 cash and non-depreciable real property P with a fair market value of $10,000 and an adjusted tax basis of $6,000. Ron contributes $10,000 cash and non-depreciable real property R with a fair market value of $10,000 and an adjusted tax basis of $10,000. Renee contributes $20,000 cash. On December 31, 1998, Renee withdraws from the partnership, receiving property P and R in complete liquidation of her partnership interest. Since the distribution occurs within 5 years from the date the property was contributed (*See PTM 2510*), the distribution is treated as a sale of property P to Renee. Phyllis has to recognize a $4,000 gain (assuming the fair market value of the property at the time of distribution is also $10,000 and the adjusted tax basis remains at $6,000). Ron would not have to recognize any gain on the distribution of property R since property R was not § 704(c) property (i.e., there is no difference between fair market value and adjusted tax basis at the time of contribution).*

***Example 2**: On January 1, 1994, Phyllis, Ron, and Renee form a partnership. Phyllis contributes non-depreciable real property P1 with a fair market value of $10,000 and an adjusted tax basis of $6,000 and non-depreciable real property P2 with a fair market value and an adjusted tax basis of $10,000. Ron and Renee each contribute $20,000 cash. Since property P1 is a § 704(c) property, the partnership uses the remedial method of making § 704(c) allocation (*See PTM 2400*).*

On December 31, 1997, property P1 is distributed to Renee in a current distribution. At the time of distribution, the fair market value of the property is $7,000. Since the distribution occurs within a 5-year period, the distribution is treated as a sale that results in a built-in gain of $1,000 ($7,000 fair market value less $6,000 adjusted tax basis). All of this gain is allocated to Phyllis. The partnership also recognizes a book loss of $3,000 ($10,000 original fair market value less $7,000 current fair market value). The book loss of $3,000 is allocated equally to Phyllis, Ron and Renee. Since Ron and Renee (the non-contributing partners with regard to property P1) are allocated $2,000 of book loss, under the remedial method, they would also have to be allocated $2,000 of tax loss to match their share of book loss. As a result, an offsetting remedial allocation of $2,000 of tax gain must also be allocated to Phyllis. Phyllis will recognize $3,000 total gains ($1,000 of § 704(c) built-in gain and $2,000 of remedial gain) on the distribution of property P1 to Renee. [See Treas. Reg. § 1.704-4(a)(5), Ex. (3).]

2510 Effective Dates

The **seven-year** rule applies to property contributed to a partnership **on or after June 9, 1997.** [Act § 1063(b)(1), PL 105-34, 8/5/97]

With respect to property contributed to a partnership **before June 9, 1997**, gain or loss was recognized if the property was distributed within **five years**. [IRC § 704(c)(1)(B) before amended by PL 105-34, 8/5/97, Act § 1063(a),] If on June 8, 1997, there is a binding contract in effect for contributions of property and the contract provides for a fixed amount of property, the five-year period applies. [Act §1063(b)(2), PL 105-34, 8/5/97]

With respect to property contributed to a partnership before **October 4, 1989**, neither the five-year rule nor the seven-year rule of this section applies. [§7642(b), PL 101-239, 12/19/89] Note: Before the amendment of § 704(c) by the Omnibus Budget Reconciliation Act of 1989 (1989 RRA), the contributing partner did not recognize any gain on distribution of the contributed property to other partners (§ 731(b). Thus, the contributing partner could defer taxation on the gain until disposition of his partnership interest. To prevent such lengthy deferral, § 704(c)(1)(B) was added by the 1989 RRA (P.L. 101-239 § 7642(a)), effective with regard to property contributed to a partnership after October 3, 1989, in tax years after such date.

For distributions by a partnership to a partner before **January 9, 1995**, the seven-year rule of this section does **not** apply. [Treas. Reg. § 1.704-4(g)] (Note:

Regulations under § 704(c)(1)(B) were issued in December 1995 (See T.D. 8642, 60 Fed. Reg. 66727 (12/26/95), effective with respect to distributions of property by a partnership to a partner on or after Jan. 9, 1995.) Although the federal law changed in 1997 to seven years, the regulations can still be used.

California Conformity:
Federal changed to the seven-year rule in 1997, for contributions made after 6/8/97. California conformed to those changes in August of 1998 (AB 2797, Ch. 322) when the specified date (§17024.5) was changed to incorporate the IRC as it read on 1/1/98 for taxable years beginning on or after 1-1-98. This means, for California purposes, the five-year rule remained in effect for contributions made until 12-31-97. Accordingly, there is a difference between California and federal for property contributed to partnerships from 6/5/97 until 12/31/97. If the partnership ends up distributing these properties after 5 years, but before 7 years, then the contributing partner will have to recognize gain for federal purposes, but not for California.

Summary:

- For property contributed before 10/4/89, no gain is recognized regardless of the date the property was distributed to the partner.
- Property that was contributed to the partnership after 10/4/89 and distributed to the partner on or after 1/9/95 is subject to the five-year rule. (Thus, if only one of the two conditions is met, no gain is recognized (e.g., property contributed after 10/4/89 but distributed before 1/9/95)).
- If property is contributed after 6/8/97 and distributed within seven years from the date of the contribution, then gain is recognized. (except as noted above for California's nonconformity).

2520 Fair Market Value

The fair market value of the distributed § 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.

The fair market value assigned by a partnership to the distributed § 704(c) property is regarded as correct, provided that the value reflects the arm’s-length negotiation and the partners have sufficiently adverse interests. [Treas. Reg. § 1.704-4(a)(3)]

2600 SEVEN-YEAR PERIOD

The Seven-year period mentioned at PTM 2500 begins on and includes the date of contribution.

IRC § 708(b)(1)(B) termination:

- If a partnership terminates under § 708(b)(1)(B) (i.e., termination due to sale of 50 percent or more of total partnership interest), a new seven-year period with regard to built-in gain or loss **does not** begin for each partner (i.e., the seven-year period starting at the time the property is originally contributed by the partner to the partnership continues to run as if the new partnership were the terminated partnership. A subsequent distribution of the § 704(c) property by the new partnership to a partner is subject to the seven-year rule of this section to the same extent that a distribution by the terminated partnership would have been subject to the seven-year rule.) [Treas. Reg. § 1.704-4(c)(3)]

- The above rule applies to terminations under § 708(b)(1)(B) that occur on or after May 9, 1997. For terminations occurring on or after May 9, 1996, the above rule may apply if the partnership and its partners apply the rule to the terminations in a consistent manner. [Treas. Reg. § 1.704-4(a)(4)]

2610 Character of Gain or Loss

When a § 704(c) property is distributed within the 7-year period, the gain or loss recognized by the contributing partner has the same character as the gain or loss that would have resulted if the distributed property has been sold by the partnership at the time of the distribution. [Treas. Reg. § 1.704-4(b)(1)]

Example: *Dave contributes non-depreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000 for a 10 percent interest in* *the partnership. Linda contributes $90,000 cash for the remaining 90% interest. The partnership is formed on January 1, 1995. On December 31, 1998, the property is distributed to Linda in a current distribution. The property is going to be used in a trade or business of Linda.*

Dave will recognize a built-gain of $6,000 (assuming the fair market value of the property remains at $10,000). Since the property is not a capital asset in Linda's hands and she holds more than 50 percent interest in partnership capital and profits, the character of the gain on the sale of the property to Linda is ordinary income under §707(b)(2). Thus, the character of the $6,000 gain to be recognized by Dave is ordinary income. [See Treas. Reg. § 1.704-4(b)(2), Ex.]

2620 Exceptions

The seven-year recognition rule **does not** apply to property contributed to the partnership on or before June 9, 1997. [Treas. Reg. § 1.704-4(c)(1)]

The seven-year recognition rule of this section **does not** apply if:

- the contributing partner receives an interest in the § 704(c) property contributed by that partner (and no other property); and
- the built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to the contributing partner under the deemed-sale distribution of this section. [Treas. Reg. § 1.704-4(c)(2)]

***Example**: In exchange for a 50 percent interest in a partnership, Patricia contributes non-depreciable real property P with a fair market value of $20,000 and an adjusted tax basis of $10,000 on January 1, 1995. (Thus, the built-in gain at the time of contribution is $10,000.) On December 31, 1998, the partnership liquidates. Patricia receives, in complete liquidation of her interest in the partnership, 75 percent interest in property P (the remaining 25 percent interest is distributed to the other partner). At the time of the liquidating distribution, property P has a fair market value of $40,000. Patricia's share in the built-in gain in property P at the time it is distributed to Patricia is $20,000 computed as follows:*

Fair market value		*$40,000*
Percentage of interest		*.75*
Fair market value received		*$30,000*
Less: basis in the partnership	*(*)*	*(10,000)*

interest
Built-in gain on distribution *$20,000*

(*) Patricia original basis in the partnership interest is $10,000, the carry-over basis in her contributed property. Assume, for simplicity, her basis remains the same from 1/1/95 through 12/31/98.

Since (1) property P is distributed back to Patricia and (2) the built-in gain at the time of distribution ($20,000) is greater than the built-in gain at the time property P is contributed ($10,000), Patricia does not have to recognize any gain on the distribution of a portion (25 percent) of property P to the other partner. [See Treas. Reg. § 1.704-4(c)(7), Ex.]

2630 Complete Transfer to Another Partnership

The seven-year recognition rule does not apply in the following situation:

Partnership A transfers all of its assets to partnership B in an exchange governed by § 721 (non-recognition of gain or loss on contribution). Partnership A immediately liquidates and distributes its interest in partnership B to its partners. All of the transactions (the transfer of the assets from A to B, the liquidation of A, and following distribution) are parts of the same plan or arrangement.

A subsequent distribution of § 704(c) property by partnership B to a partner of B will trigger the application of the seven-year rule to the same extent that a distribution by partnership A would have been subject to the seven-year rule. [Treas. Reg. § 1.704-4(c)(4)]

A similar rule is provided under § 1.737-2(a) in the context of § 737.

2640 Incorporation of a Partnership

The seven-year recognition rule does not apply if:

- the partnership is incorporated, and the incorporation occurs by any method except the method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation, and
- the partnership is immediately liquidated as part of the incorporation transaction. [Treas. Reg. § 1.704-4(c)(5)]

A similar rule is provided under § 1.737-2(c) in the context of § 737.

2650 Undivided Interests

The seven-year recognition rule does not apply to a distribution to the contributing partner of an undivided interest in the § 704(c) property to the extent it does not exceed the undivided interest originally contributed by such partner.

A similar rule is provided under § 1.737-2(d)(4) in the context of § 737.

2660 Like-Kind Exchange of Section 704(c) Property

As discussed at (PTM 2180), property received by a partnership in exchange for § 704(c) property in a non-recognition transaction is treated as a § 704(c) property for the purposes of the seven-year rule. [Treas. Reg. § 1.704-4(d)(1)]

If a partnership distributes a § 704(c) property to a partner other than the contributing partner and like-kind property (within the meaning of § 1031) is distributed to the contributing partner no later than the earlier of:

- 180 days after the date of the distribution to the non-contributing partner, or
- the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the non-contributing partner,

the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under the seven-year recognition rule is reduced by the amount of the built-in gain or loss in the distributed like-kind property that the contributing partner receives. The contributing partner's basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution. [Treas. Reg. § 1.704-4(d)(3)]

***Example**: Susan, Lori, and Chris form a partnership on January 1, 1995. Susan and Lori each contribute $50,000 cash. Chris contributes non-depreciable property C with a fair market value of $50,000 and an adjusted tax basis of $20,000. The partnership purchases non-depreciable property X which is of a like-kind property to property C for $15,000.*

On December 31, 1988, property C is distributed to Susan in a current distribution. At the same time, property X is distributed to Chris in a current distribution. At the time of distribution, property X has a fair market value of $25,000. Assume the distribution of property X to Chris does not result in the *recharacterization of Chris' contribution of property C as a disguised sale under § 1.707-3. The tax impact of the two distributions is as follows:*

- *Distribution of property X to Chris: Chris' basis in the partnership interest is $20,000 (the carried-over basis in the contributed property, assuming, for simplicity, there is no change in his partnership basis since January 1, 1995 through December 31, 1998). Property X has an adjusted tax basis of $15,000 in the hands of the partnership. Under the general rule of § 732(a)(1), Chris' basis in property X is the lesser of his basis in the partnership interest or the adjusted tax basis of the property in the hands of the partnership. In this instance, his basis in property X is $15,000. Thus, Chris has $10,000 of built-in gain in property X ($25,000 fair market value less $15,000 adjusted tax basis). There is no gain to be recognized from the distribution of property X to Chris.*
- *Distribution of Property C to Susan: Property C has a built-in gain of $30,000 at the time Chris contributes it to the partnership. Assuming the property's fair market value is the same as when it is contributed (i.e., $50,000), Chris has to recognize a built-in gain of $30,000 under the seven-year recognition rule when the property is distributed to Susan. However, this gain is reduced by the built-in gain in property X in the hands of Chris ($10,000). Thus, Chris recognizes only $20,000 of gain on distribution of property C to Susan.*
- *Chris' basis in his partnership interest is as follows:*

Initial Basis (1/1/95)	*$20,000*
Less: distribution (property X)	*(15,000)*
Add: Gain recognized on distr. of property C	*20,000*
Basis on 12/31/98	*$25,000*

2670 Transfer of Partnership Interest

If a contributing partner transfers all or a portion of his partnership interest, the transferee is treated as the contributing partner for purposes of the seven-year recognition rule to the extent of the share of the built-in gain or loss allocated to the transferee partner. [Treas. Reg. § 1.704-4(d)(2)]

Observation: It is interesting to note that the regulation does not provide for the situation when the contributing partner retires before the distribution of a contributed property that triggers the seven-year rule. It appears that if the contributing partner is no longer a partner, the seven year rule cannot be applied-1[1] However, the retired partner is considered as a partner to the extent he/she is receiving payments from the partnership.

2680 Basis Adjustments

Contributing Partner's Basis in Partnership Interest: The contributing partner's basis in his/her partnership interest is increased by the amount of the gain, or decreased by the amount of the loss, recognized by the partner under the seven-year recognition rule. The increase or decrease is taken into account in determining:

- the contributing partner's adjusted tax basis under § 732 for any property distributed to the partner in a distribution that is part of the same distribution as the distribution of the contributed property (except the like-kind distribution described in PTM 2660; see note below), and
- the amount of the gain recognized by the contributing partner under § 731 or §737, if any, on distribution of money or property to the contributing partner that is part of the same distribution as the distribution of contributed property. [Treas. Reg. § 1.704-4(e)(1)]

Note: The above rule does not apply in a distribution of like-kind property. As in the Example at PTM 2660, Chris's basis is increased by the distribution of property C to Susan. However, this increase is not taken into account in computing his adjusted tax basis in the partnership interest for the purpose of determining the built-in gain of property X which is distributed to Chris.

Partnership's Basis in Partnership Property: The partnership's adjusted tax basis in the distributed § 704(c) property is increased or decreased immediately before the distribution by the amount of the gain or loss recognized by the contributing partner under the seven-year recognition rule. Any increase or decrease in basis is therefore taken into account in determining the distributee partner's adjusted tax basis in the distributed property under § 732. [Treas. Reg. § 1.704-4(e)(2)]

IRC § 754 Adjustments: The basis adjustments to partnership property mentioned in the above paragraph are not elective and must be made regardless of whether the partnership has an election in effect under § 754. [Treas. Reg. § 1.704-4(e)(3)]

***Example**: Allen contributes property A to partnership ABC in exchange for an interest in the partnership. At the time of contribution, the property has a fair market value of $10,000 and an adjusted tax basis of $4,000. Four years later, property A is distributed to Brian, a partner of partnership ABC. Allen recognizes the built-in gain of $6,000 and his partnership basis is increased by the gain. The* *partnership's basis in property A immediately prior to the distribution is increased from $4,000 to $10,000. Thus, Brian's basis in distributed property A is the lesser of $10,000 or his adjusted tax basis in the partnership interest under § 732(a)(1). [See Treas. Reg. § 1.704-4(e)(4), Ex.]*

2690 Anti-abuse Rule

- In general, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of § 704(c)(1)(B), the transaction may be recast for federal income tax purposes. [Treas. Reg. § 1.704-4(f)(1)]

- The purpose of § 704(c)(1)(B) is "to eliminate the inconsistent treatment of sales and distributions by a partnership and thereby prevent partners from circumventing the rule requiring pre-contribution gain or loss on contributed property to be allocated to the contributing partner by distributing the property to another partner." [PS-76-92; PS-51-93, 1995-1 CB 1001, 1002]

- The determination of whether a tax result is inconsistent with the purpose of §704(c)(1)(B) is determined based on all the facts and circumstances. [Treas. Reg. § 1.704-4(f)(1)] For illustration of the anti-abuse rule, see the Examples provided in § 1.704-4(f)(2).

2700 Reserved

2800 CASE LAW

2900 AUDIT ISSUES AND TECHNIQUES

This section discusses the potential audit issues and techniques regarding:

- Allocations of Partnership income or loss (PTM 1000)
- Allocations of Non-recourse Deductions (PTM 3000)
- Allocations with respect to Contributed Property (PTM 2000)

2910 Determination of A Partner's Share of Partnership Items

Issue: Determine if a partner's distributive share of each item of partnership income, gain, loss, deduction, and credit has substantial economic effect or is consistent with the partner's interest in the partnership.

Scoping Techniques:

- In general, the allocation of partnership items to a partner should be in proportion to his profit or loss sharing ratios, as reported on the schedule K-1 issued to such partner. This can be determined quickly by multiplying the profit or loss sharing ratios to the total partnership income or loss as reported on the schedule K. If the amount computed by the auditor appears substantially different from the amount reported on the schedule K-1 regarding each partnership separately reported item, the difference may be an indication of a special allocation.
- In some situations, the above quick check is impossible because the profit or loss sharing ratio is reported on the schedule K-1 as "various". However, the auditor may verify if the same ratio is used to allocate the items of income or loss to such partner (e.g., operating income on line 1, rental income on line 2 and 3, portfolio income on line 4, gain on line 6, and other gain on line 7 of the schedule K). If different ratios are used for allocation of different items or income or loss, the partner might have been specially allocated certain partnership items. In addition, the auditor may request the partnership return filed for another taxable year and compare the allocation ratios of one year to the other with regard to each partner. If

the ratios appear to have changed substantially from one year to the other, the auditor may want to examine the issue.

- In other situations, the partnership schedule K may show net operating income but the schedule K-1 issued to the partners may show losses. For instance, line 1 of schedule K may show the partnership's total operating income of $10 but line 1 of the schedule K-1 issued to partner A shows an operating loss of $4 while line 1 of the schedule K issued to partner B shows an operating income of $14. Although the net amount on line 1 of all the schedules K-1 matches the amount on the schedule K ($14 - 4 = $10), each partner does not appear to have a proportionate share of such income.
- An allocation may be in accordance with a partner's interest in a partnership but may not be respected for lack of substantial economic effect. Until a partnership agreement is obtained, it is unrealistic to determine the economic effect of an allocation. However, if the schedule K-1 issued to a partner shows a negative capital account balance caused by an allocation of the partnership loss in the current taxable year <u>and</u> there is no indication of the partner's share of partnership liabilities (shown on line – of the schedule K-1), the auditor should verify if such allocation is valid and deductible by the partner (under the provisions of §§ 704(b), 705, 465, and 469.) The partner's individual return should be requested to determine the effect of the allocation and how such partner deducts the loss.

Information and Documents to be Requested:

The following list is not inclusive. It is important the auditor tailor his information request to the particular items or issues identified on the return.

- Copies of the partnership agreement and all amendments from inception to the audit tax year, including all side agreements among and between partners.
- Schedule computing each partner's capital account from inception to the current year. (It should be noted that although a partnership is not required to maintain its partners' bases in their partnership interests, it is required to maintain the partners' capital accounts pursuant to § 704(b).) If the partners' book basis capital accounts are different from the tax basis capital accounts, the auditor may want to request the tax basis capital account schedule as well.
- Explanation of the items (that appear to have been specially) allocated to certain partners and documentary evidence supporting that the allocations have substantial economic effect.

Based on the response from the taxpayers, the auditor may request other additional relevant and reasonable information or documents. Since part of the substantial economic effect tests involves the tax effect of the allocation at the partners' level, the auditor may want to obtain copies of the partners' individual returns from in house or from the partners.

Law Application:

- The allocation rules are discussed in PTM 1000. In general, an allocation is respected if it has substantial economic effect or is in accordance with the partner's interest in the partnership.
- The substantial economic effect consists of the economic effect tests and the substantiality test.
- For issues involving partner's interest in the partnership, see PTM 2950.

The Economic Effect: To test the economic effect of an allocation, the auditor should verify the following:

- Does the partnership agreement provide that the partners' capital accounts have to be maintained according to § 704(b) Regulations? Does the partnership actually maintain the partners' capital accounts? Ask the partnership for the schedule computing the partners' capital accounts. See PTM 1400 for the maintenance rules.

- Does the partnership agreement provide that distributions in liquidation of the partnership should be made in accordance with the partners' positive capital account balance? See PTM 1160 for discussion of the law. See PTM 2930 for discussion of audit issues.

- Does the partnership agreement require all partners to restore the deficit balances in their capital accounts? See PTM 1130 for discussion of the law. See PTM 2920 for discussion of audit issues.

- If the partnership agreement contains only the first two requirements but not the deficit capital account restoration obligation, does it meet the requirements under the Alternative economic effect test? See PTM 1140 for discussion of the law.

- If the partnership agreement does not contain any of the above requirements, does it meet the requirements under the economic effect equivalence test? See PTM 1180.

The above economic effect requirements have been applied in various court cases [See, e.g., Interhotel Company, LTD., TC Memo 1997-449.] The final test (question # 5) is referred to by some tax authors as the "dumb but lucky" rule that may be significant only in the simplest of situations. [See McKee et al, para 10.02[1]; 3 ed. 1997]

The Substantiality Test: If an allocation meets the above economic effect tests, it must also meet the substantiality test. See PTM 1200 for discussion of the law. The auditor needs to request the partner's returns to determine if there is a shifting in tax consequences due to the allocation.

2920 Obligation to Restore Deficit Capital Accounts

The requirements to restore the deficit capital accounts are discussed at PTM 1130. It appears that this requirement has to be expressly stated in the partnership agreement in order to establish the "economic risk of loss".

Based on case law, this is the area where a number of issues have been identified.

- If the partnership agreement is silent regarding the restoration obligation, can a similar provision under the state law satisfy such requirement? An argument raised by the taxpayer is that even though the partnership agreement does not contain the requirement to restore a deficit capital account, he is obligated to restore it under state or local law (e.g., under the Uniform Partnership Act). In Hogan, the taxpayer argued that under Pennsylvania law, general partners are obligated to restore any deficits in their capital accounts at liquidation. The Tax Court noted that the state law cited by the taxpayer did not have any express provision for restoration of the deficit capital accounts. In addition, the state law should only be used "for guidance as an interpretative aid and that the partnership agreement was the controlling factor."[12] Taxpayers are advised not to rely on state law to satisfy this requirement because the definition of "capital accounts" for state law purposes may not coincide with the tax capital account definition of the Regulations-1[3]
  Joseph M. Hogan, 59 TCM 870 (1990). See also Goldfine v. Commissioner, 80 TC 843 (1983).

- Is the guarantee of a partnership liability tantamount to "economic risk of loss"? A taxpayer claimed that his guarantee of a mortgage held by a bank provided him with the economic risk of loss. The Tax Court disagreed with the taxpayer's position, stating that (1) the creditors could look to the securing property itself for satisfaction of the liability; and (2) if that did not satisfy the liability, the taxpayer is only one of five co-guarantors; there is no assurance that he, rather than someone else, would be called upon to pay off the mortgage; (3) the debtors were not insolvent during any of the years at issue, and (4) the key issue is whether the taxpayer "had an obligation to restore the negative capital account balance on liquidation, not whether (the taxpayer) ultimately may pay the mortgage.
  PNRC Limited Partnership, TC Memo 1993-335.

- Does the lack of an express deficit restoration requirement invalidate a special allocation in all situations? No, provided that the partners' capital accounts are always positive. In fact, the economic risk of loss becomes an "issue" only if an allocation renders the partners' capital accounts negative (i.e., are the partners required to restore the deficit balances?). However, there is an exception to this rule, as discussed at PTM 2930.
  Jack D. McGuffey, TC Memo. 1989-267. See also Fink v. Commissioner, TC Memo. 1984-669; Dibble v. Commissioner, TC Memo. 1984-589.

- The existence of a "chargeback" provision in the partnership agreement (i.e., future profits will be allocated to offset the previous loss which reduces the capital account negative) is **not** a substitute for the restoration requirement in the partnership agreement. In Sam J. Vecchio, the partnership agreement did not require the partners to restore their deficit capital account balances but required that such partner's share of subsequent profits be applied to restore the deficit account. The Tax Court ruled that the allocation does not have substantial economic effect because the "chargeback" provision in the partnership agreement did not "redefine his share of such profits, allocate a greater share of the profits to such partner, or require a partner to contribute additional funds to the partnership to restore the deficit amount." Note that the holding of this case is for the purpose of determining if a special allocation of a partnership loss is valid given the above requirements in the partnership agreement. In situations wherein a special allocation of losses has economic effect (because the partner is required to restore his deficit capital account), the partnership is allowed to specially allocate gain to such partner in later years to offset the prior deductions which created the negative balance.
  Sam J. Vecchio, 103 TC 170, 1994.

- Note that the requirement for the partners to restore their deficit capital accounts under sec. 704(b) is for the purpose of validating partnership allocations. When the partnership liquidates and the partners with deficit capital accounts do not restore their deficit balance, the partners may realize capital gain under the operation of other sections. In general, a partner's "negative capital account" indicates the inclusion of partnership liabilities in a partner's partnership basis. When his interest in the partnership is liquidated and he does not restore the deficit balance through contributions or personal assumptions of the partnership liabilities, the relief of such liabilities constitutes a deemed cash distribution under § 752. If the deemed distribution exceeds the partner's basis in the partnership interest, the partner realizes gain under § 731 and the gain is treated as capital gain from the sale of his partnership interest.
  Gene and Donna Young, 94-SBE-017, December 14, 1994.

2930 Liquidating Distribution Requirements

In order for a partnership allocation to have substantial economic effect, the partnership agreement must contain the requirement that distributions in liquidation of the partnership must be made pursuant to the partners' positive capital account balances (See PTM 1120). If the liquidating distribution is not made on the basis of the partners' positive capital accounts, an allocation may not be valid.

As stated at PTM 2920, the absence of a requirement to restore the deficit capital accounts may not invalidate a special allocation if the allocation does not render the capital account negative. However, if the partnership agreement does not require that liquidating distributions must be made pursuant to the capital account balances, an allocation may be disallowed even if it does not cause a negative balance in the partners' capital accounts. In McDuffey, the taxpayer argued that she should be specially allocated the partnership loss up to $35,600, the balance of her capital account. The Tax Court determined that the allocation did not have substantial economic effect because (1) the taxpayer was not required to restore her deficit balance and (2) regardless of her capital account balance, she would be distributed proceeds from the sale of the property in proportion to her percentage of ownership of the partnership. Thus, even though the specially allocated loss may not reduce a partner's capital account to zero, such allocation does not have economic effect because it does not affect the dollar amount she would receive upon liquidation, as stated by the Court: "While the (taxpayer) would receive a disproportionate share of the partnership's tax loss, she would not suffer any corresponding reduction in the dollars that she would receive upon liquidation."

Jack D. McGuffey, TC Memo. 1989-267. See also Allison v. United States, 701 F.2d at 939.

2940 Partnership Agreement

For discussion of the law, see PTM 1170, PTM 1650.

When requesting a partnership agreement, the auditor should request the original agreement and all subsequent modifications or arrangements among and between partners.

An amendment of a partnership agreement must be agreed upon by all partners pursuant to § 761(c). If there is no evidence showing that all partners are aware of and agree with the amendment, such amendment may not be valid. [Sam J. Vecchio, 103 TC 170, 1994]

Interactions with local law: The partnership agreement includes any provisions of federal, state, or local law that governs the affairs of the partnership. However, as noted at PTM 1180, the requirement to restore a deficit capital account must be provided for in the partnership agreement and state law should not be relied on to satisfy the requirement.
Girgis v. Commissioner, TC Memo. 1987-556; Sellers v. Commissioner, TC Memo. 1977-70.

Oral Partnership Agreement: A partnership agreement can be oral (§ 1.761-1(c)). In the case of an oral partnership agreement, the auditor should consider all of the facts and circumstances surrounding the formation and operation of the partnership in determining the sharing ratios.
Reed v. Commissioner, TC Memo. 1978-58; Ryza v. Commissioner, TC Memo. 1977-64.
In Hogan, the partners claimed that the partnership agreement expressly provided for the deficit restoration obligation, although the partnership had no written partnership agreement. However, the Court determined that the allocation had no economic effect because during their testimony, the three partners were unable to recall "having specially agreed upon what would occur if a partner's interest was to be allocated, if the partnership itself was liquidated, or what effect the death of a partner would have on the partnership."
Joseph M. Hogan, 59 TCM 870 (1990).

In particular, the auditor should:

- request the taxpayer to state in writing the partners' (oral) agreement regarding a certain item or requirement;
- verify such statement with other partners.
- scrutinize a transaction, as requested under the law, if the partners are related parties.

Transfer of Partnership Interest: See PTM 1500 for law discussion. When a partner disposes of less than his entire interest, the determination of both transferor's and transferee's distributive share of partnership items must be made pursuant to §706(c)(a)(2) and the regulations promulgated thereunder. Such determination cannot be altered by a modification of a partnership agreement, such as to retroactively allocate partnership losses to new partners. [Rodman v. Commissioner, 542 F.2d 845, [38 AFTR 2d 76-5840](2d Cir. 1976)]

2950 Partners' Interests in the Partnership

The determination rules are discussed at PTM 1600, PTM 1610, and PTM 1620-1[4] In PNRC Limited Partnership, TC Memo 1993-335, the Tax Court suggested another method by comparing the manner in which distributions and contributions would be made if all partnership property were sold at book value and the partnership were liquidated at the end of the taxable year at issue to the manner in which distributions and contributions would be made if all partnership property were sold at book value and the partnership were liquidated at the end of the prior taxable year.

2960 Burden of Proof

If the auditor identifies partnership items which (1) are not allocated in accordance with the partners' interests in the partnership, or (2) are allocated in accordance with the partners' interests in the partnership but cause a deficit in the partners' capital accounts, he should request the taxpayer to explain the allocation and provide supporting authority. The burden of proof is on the taxpayer to show that a partnership allocation has substantial economic effect. [Sam J. Vecchio, 103 TC 170, 1994.]

The taxpayer is required to prove the substantial economic effect of not only the "special allocations" but also of all partnership allocations. [Joseph M. Hogan, 59 TCM 870 (1990).]

The substantial economic effect is determined on a year-to-year basis-1[5] Prior acceptance of allocation by agent does not preclude the government to treat the item differently in later years. [Interhotel Company, LTD., TC Memo 1997-449.]

3000 CAPITAL ACCOUNTS- ALLOCATIONS OF NON-RECOURSE DEDUCTIONS

3010 ALLOCATION ATTRIBUTABLE TO NON-RECOURSE LIABILITIES

Under the general allocation principle of §704(b) Regulations (discussed in PTM 1000), an allocation of a partnership's taxable income or loss to its partners must have substantial economic effect. For instance, a partner who is allocated a partnership's taxable loss has to bear the economic burden with regard to such allocation. However, this principle is not applicable when a partnership borrows money on a non-recourse basis to finance its operating expenses (deductions) because the economic burden is borne by the creditors, not the partners. Thus, deductions attributable to non-recourse liabilities (referred to as "*non-recourse deductions*") are allocated based on a different set of rules under § 704(b) Regulations.

The allocation rules are based on several concepts:

To determine the amount of *non-recourse deductions* (i.e., which of the partnership's deductions are attributable to non-recourse liabilities), it must first determine the amount of *partnership minimum gain*. An increase in partnership minimum gain during a taxable year causes the partnership to have non-recourse deductions. (See PTM 3070.)

The non-recourse deductions are then allocated to partners based on certain rules discussed at PTM 3020. The allocation of non-recourse deductions to a partner increases his share of partnership minimum gain.

Under the *minimum gain chargeback* rules, the partner who shares in the partnership's minimum gain has to be allocated the partnership's income or gain in an amount equal to his share of the minimum gain. (See PTM 3340)

***Observation**: Though the above concepts are simple, the applicable rules may be complicated in certain situations. It may be useful for the auditor to remember the relationship among these concepts when following the discussion of the applicable rules.*

3020 GENERAL ALLOCATION PRINCIPLES

When a partnership realizes losses, deductions, or § 705(a)(2)(B) expenses (See PTM 1480 – PTM 1495) that are funded by non-recourse borrowing, the allocation of these items (referred to as *non-recourse deductions*) cannot be based on the partners' share of economic risk of loss because the creditor alone bears any economic burden corresponding to those allocations. Thus, <u>non-recourse deductions must be allocated in accordance with the partners' interest in the partnership</u>. [Treas. Reg. § 1.704-2(b)(1)]

In order for allocations of non-recourse deductions to be <u>**deemed**</u> in accordance with the partners' interests in the partnership, they have to meet a set of requirements provided in § 1.704-2(b)(e). (See PTM 3030)

If those requirements are not satisfied, the partners' distributive shares of non-recourse deductions will be determined in accordance with the partners' <u>overall economic interests in the partnership</u> provided under § 1.704-1(b)(3) (See PTM 1600) [Treas. Reg. § 1.704-2(b)(1)]

For definitions of non-recourse liabilities, partner non-recourse liabilities, partnership minimum gain, and minimum gain chargeback, see PTM 3030 through PTM 3050

3030 REQUIREMENTS FOR ALLOCATION OF NON-RECOURSE DEDUCTIONS

Allocations of non-recourse deductions are **deemed** to be in accordance with the partners' interests in the partnership only if **all** of the following requirements are satisfied:

1. Throughout the full term of the partnership, the economic effect requirements (See PTM 1120) under § 1.704-1(b)(2)(ii)(b) are satisfied (i.e., the partners' capital accounts are maintained in accordance with § 704(b) rules; liquidating distributions are made in accordance with the partners' positive capital account balances; and partners with deficit capital accounts have an unconditional obligation to restore the deficit balances or agree to a qualified income offset);
2. Beginning in the first taxable year of the partnership in which there are ***non-recourse deductions,*** and thereafter throughout the full term of the partnership, the partnership agreement provides that allocations of non-recourse deductions must be made in a manner that is reasonably consistent with the allocations of some other significant partnership items. These "significant partnership items" are items that have substantial economic effect and are attributable to the property securing the non-recourse liabilities;
3. Beginning in the first taxable year that the partnership has non-recourse deductions or makes a distribution of proceeds of a non-recourse liability that are allocable to an increase in partnership ***minimum gain*** and thereafter throughout the full term of the partnership, the partnership agreement contains the ***minimum gain chargeback*** requirement (See PTM 3150)
4. All other material allocations and capital account adjustments are recognized under § 1.704-1(b) (i.e., partnership's allocations and capital accounts are in accordance with the rules discussed in PTM 1000 through PTM 3500. [Treas. Reg. § 1.704-2(e)]

In essence, the above requirements provide that if a partnership has non-recourse deductions (determined based on minimum gain), these non-recourse deductions must be allocated in accordance with the allocations of other significant items attributable to the property securing the non-recourse liabilities, and the partners who are allocated these non-recourse deductions must be subject to the minimum gain chargeback rules.

3040 DEFINITION OF NON-RECOURSE LIABILITIES

- A non-recourse liability, as defined under § 1.752-1(a)(2), is a liability for which **no partner** or a related person bears the economic risk of loss. [Treas. Reg. § 1.704-2(b)(3)] In simple terms, if a partnership fails to repay a non-recourse liability, the lender has no recourse against any partners except to foreclose on the assets used to secure the non-recourse loan.
- For further discussion of non-recourse liabilities, (See PTM 5490)
- For determination of the economic risk of loss, (See PTM 5510)
- If the non-recourse liabilities are made or guaranteed by a partner or a related person, the non-recourse debt is treated as a "partner non-recourse debt". (See PTM 3200.)

3050 DEFINITION OF PARTNERSHIP MINIMUM GAIN

The first step in determining the amount of non-recourse deductions is to determine if the partnership has minimum gain.

A partnership minimum gain is the excess of the non-recourse liability over the adjusted tax basis of the partnership property that it encumbers.

Non-recourse liability - Adjusted tax basis = Minimum gain

Important: If the adjusted tax basis of the property is different from its book basis, the minimum gain is computed based on book basis. This rule applies to all computation of minimum gain or increases in minimum gain. (See PTM 3072)

Thus, if the adjusted tax basis of the property decreases (e.g., due to depreciation), or if the partnership borrows additional non-recourse debts encumbered by the same property, the partnership minimum gain will increase.

If the non-recourse liability is reduced (e.g., through payments by the partnership), the partnership minimum gain will decrease. [Treas. Reg. § 1.704-2(b)(2)]

For computation of increases and decreases in partnership minimum gain, See PTM 3060.

***Example**: Brian and Larry form a partnership with each contributing $1,000 to the partnership. The partnership obtains a non-recourse loan of $8,000 from an unrelated party and purchases a depreciable property for $10,000. The partnership generates $2,000 of depreciation in each of the first five years.*

At the end of year 3, the outstanding balance of the non-recourse liability is $7,000 and the adjusted tax basis of the property is $4,000 ($10,000 cost basis less $6,000 accumulated depreciation for three years). The partnership minimum gain at the end of year 3 is $3,000 ($7,000 non-recourse liability less $4,000 adjusted tax basis).

Assuming in year 4, the property appreciates in value to $15,000. The partnership borrows a second non-recourse liability of $3,000 and distributes the proceeds to Brian and Larry. No principal payments are made on the first non-recourse liability during year 4. The partnership minimum gain at the end of year 4 is computed as follows:

Total non-recourse liabilities:	*($ 7,000 + 3,000)*	*$10,000*
Adjusted tax basis(*)		*2,000*
Partnership minimum gain		*$8,000*

(*) $10,000 cost basis less $8,000 accumulated depreciation for four years.

3060 COMPUTATION OF PARTNERSHIP MINIMUM GAIN

The computation of the amount of partnership minimum gain and the net increases or decreases in partnership minimum gain during a partnership taxable year is important since it determines how much of the partnership deductions are attributable to non-recourse liabilities (referred to as non-recourse deductions, See PTM 3070).

The amount of partnership minimum gain is determined by first computing for each partnership non-recourse liability any gain the partnership would realize if it disposes of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains.

- See PTM 3050 for how to determine partnership minimum gain.
- If a property is subject to more than one non-recourse liability, See PTM 3071.

The amount of partnership minimum gain also includes minimum gain arising from a conversion, refinancing, or other change to a debt instrument as described in § 1.704-2(g)(3) only to the extent the partner is allocated a share of that minimum gain. Detailed computation is provided at PTM 3500.

The net increase or decrease in partnership minimum gain in any partnership taxable year is determined by comparing the partnership minimum gain on the last day of the current taxable year with the partnership minimum gain on the last day of the immediately preceding taxable year. [Treas. Reg. § 1.704-2(d)(1)]

For illustration of the computation of the amount of partnership minimum gain, see Example in PTM 3070

3070 COMPUTATION OF NON-RECOURSE DEDUCTIONS

Once the amount of partnership minimum gain is computed (See PTM 3060), the next step is to determine the amount of partnership non-recourse deductions. The purpose of determining which deductions generated at the partnership level are attributable to non-recourse liabilities is to determine how they (the non-recourse deductions) are allocated to partners. The amount of non-recourse deductions may be less than, equal to, or more than the partnership taxable loss. (Note that the partner who is allocated non-recourse deductions is subject to the minimum gain chargeback.)

The amount of non-recourse deductions for a partnership tax year equals:

- the <u>net increase in partnership minimum gain</u> during the year (determined under § 1.704-2(b)(d), see PTM 3060), and
- <u>reduced (but not below zero) by the aggregate distributions</u> made during the year of proceeds of non-recourse liability that are allocated to an increase in partnership minimum gain (determined under § 1.704-2(b)(h); see PTM 3140). [Treas. Reg. § 1.704-2(c)]

Increases in partnership minimum gain resulting from conversions, re-financings, or other changes to a debt instrument (See PTM 3130) **<u>do not</u>** generate non-recourse deductions.

Generally, non-recourse deductions consist first of certain depreciation deductions or cost recovery deductions and then, if necessary, a pro-rata portion of other partnership losses, deductions, and § 705(a)(2)(B) expenditures for that year. [Treas. Reg. § 1.704-2(c)] (For the ordering rules, see PTM 3300.) Thus, the non-recourse deductions may be less than, equal to, or more than the partnership's taxable loss during the year.

If the non-recourse deductions exceed the partnership losses during the year, the excess amount is carried over to the succeeding partnership taxable year. (See PTM 3330)

Example: *Laurie and Gary form a limited partnership to own and operate a rental property. Laurie, the limited partner, contributes $18,000 and Gary, the general partner, contributes $2,000. The partnership obtains a $80,000 non-recourse loan to purchase the property (on leased land) for $100,000. The loan is secured by the property and no principal payments are due for 5 years. The partnership agreement provides that Gary has to restore his negative capital account balance following his partnership interest's liquidation. Laurie, the* *limited partner, however, is not required to restore her deficit capital account balance. The partnership agreement also contains the following requirements (discussed at* PTM 3030*): partners' capital accounts maintained in accordance with the rules, liquidating distributions made in accordance with the partners' positive capital accounts, a qualified income offset, and a minimum gain chargeback. The partnership also provides that unless required by the qualified income offset and the minimum gain chargeback provisions, all partnership items are allocated 90% to Laurie and 10% to Gary until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life. Thereafter, all partnership items will be allocated equally between Laurie and Gary. Finally, the partnership agreement also provides that all partnership distributions, other than liquidating distributions, will be made 90% to Laurie and 10% to Gary until a total of $20,000 has been distributed (the $20,000 is their initial capital contributions). Thereafter, all distributions will be made equally between Laurie and Gary.*

In each of the first two years, the partnership generates the following items: rental income of $9,500, operating expenses of $1,000, interest expense of $8,000 and depreciation deduction of $9,000, resulting in a net taxable loss of $8,500 in each of those years. The allocations of these losses to Laurie (90%) and Gary (10%) have substantial economic effect. Their capital accounts are as follows:

	Laurie	***Gary***
Capital account on formation	*$18,000*	*$2,000*
Less: net loss in year 1&2	*(15,300)*	*(1,700)*
Capital account at end of year 2	*$2,700*	*$300*

In the partnership's third taxable year, it generates the same items of income and expenses as in the first two years. No distributions were made by the partnership.

In general, the determination of how to allocate the partnership taxable loss is done in the following order:

(1) *Determine if the partnership has minimum gain (if there is no minimum gain, there is no non-recourse deductions, the taxable loss is allocated in accordance with the principles discussed in Chapter 6a.);*
(2) *If there is minimum gain, determine the amount of non-recourse deductions based on the increase in minimum gain during the year (note that all or a portion of the partnership taxable loss may be attributable to non-recourse deductions, as computed below in this example);*

(3) *Once the amount of non-recourse deductions is determined, it is allocated to the partners in accordance with the rules discussed at* PTM 3040*. (Losses which are not attributable to non-recourse deductions are also allocated to partners in accordance with the rules discussed in* PTM 1000 – PTM 1495*, i.e., substantial economic effect rules, as computed below in this example.)*

The allocation of the partnership taxable loss in year 3 to Laurie and Gary based on the above order is as follows:

- *Calculation of partnership minimum gain (*See PTM 3060*): If the partnership were to dispose of the rental property at the end of year 3 in full satisfaction of the non-recourse liability of $80,000, it would realize a gain of $7,000 (cost basis of $100,000 less accumulated depreciation of $27,000 in three years to give an adjusted tax basis of $73,000). This $7,000 gain is the partnership minimum gain (i.e., the excess of non-recourse liability over the adjusted tax basis). Using the same hypothetical sale, the partnership minimum gain at the end of year 2 is zero ($80,000 recourse liability less $82,000 adjusted tax basis). Thus, the net increase in partnership minimum gain during year 3 is $7,000.)*
- *Calculation of non-recourse deductions (*See PTM 3070*): The partnership total taxable loss in year 3 is $8,500 (included in the loss is the depreciation deduction of $9,000). Since the amount of non-recourse deductions equals the net increase in partnership minimum gain during the year, the partnership non-recourse deductions for year 3 is $7,000 (out of the total loss of $8,500).*
- *Allocation of non-recourse deductions: The partnership's total taxable loss of $8,500 includes $7,000 of non-recourse deductions and $1,500 of loss (without non-recourse deduction). The taxable loss of $1,500 is allocated 90% to Laurie and 10% to Gary in accordance with the partnership agreement and this allocation has substantial economic effect (because the partnership agreement contains all the economic effect requirement (*See PTM 1120*). With regard to the $7,000 non-recourse deductions, they are also allocated in the ratio of 90/10 to Laurie and Gary, respectively. This allocation satisfies the requirement 2 at* PTM 3030 *since it is consistent with the allocation of "other significant partnership items attributable to the property that have substantial economic effect" (which, in this example, are the taxable loss of $1,500). Also, the other requirements 1, 3 and 4 at* PTM 3030 *are satisfied. Thus, the allocation of non-recourse deductions to Laurie and Gary in year 3 is deemed to be in accordance with the partners' interests in the partnership.*

	Laurie	***Gary***
Capital account at end of yr. 2	*$2,700*	*$300*
Less: net loss in year 3 (without non-recourse deductions.)	*(1,350)*	*(150)*
Less: yr. 3 Non-recourse deductions	*(6,300)*	*(700)*
Capital accounts at end of yr. 3	*($4,950)*	*($550)*

*At the end of the partnership third taxable year, Laurie and Gary's shares of partnership minimum gain are $6,300 and $700, respectively. [*See Treas. Reg. § 1.704-2(m), Ex. (1)(i).]

*Under the minimum gain chargeback rules (*See PTM 3150*), if the partnership were to dispose of the property in full satisfaction of the non-recourse liability at the end of year 3, the partnership minimum gain will be decreased from $7,000 to zero and the minimum gain will be allocated $6,300 to Laurie and $700 to Gary.*

PTM 3071 Property Subject to More Than One Liability
PTM 3072 Partnership Minimum Gain if Book/Tax Disparity
PTM 3073 Special Rule for Year of Revaluation

3071 PROPERTY SUBJECT TO MORE THAN ONE LIABILITY

- If a property is subject to more than one liability, only the portion of the property's adjusted tax basis allocated to a non-recourse liability is used to compute minimum gain. The portion of the property's adjusted tax basis allocated to the non-recourse liability is determined based on the proportionate outstanding balances of all encumbering liabilities. [Treas. Reg. § 1.704-2(d)(2)(i)]

- If a property is subject to two or more than one liabilities *of equal priority,* the property's adjusted tax basis is allocated among the liabilities in proportion to their outstanding balances. [Treas. Reg. § 1.704-2(d)(2)(ii)]

- If a property is subject to liabilities of *unequal priority*, the adjusted tax basis is first allocated to the liability of the highest priority to the extent of its outstanding balance and then to each liability in descending order of priority to the extent of its outstanding balance, until fully allocated. [Treas. Reg. § 1.704-2(d)(2)(ii)]

***Example**: Rainbow Partnership acquires a commercial building for $1,000,000 that is financed by a $800,000 non-recourse loan and a $200,000 recourse loan subordinate to the non-recourse loan. Assuming at the end of year 3, the balance of the non-recourse loan is $800,000 and the balance of the recourse loan is $150,000. The partnership's adjusted tax basis in the property is $ 850,000. Since the non-recourse loan has higher priority, the $850,000 adjusted tax basis of the property has to be allocated to the non-recourse loan to the extent of its outstanding balance, which is $800,000. Thus, there is no minimum gain at the end of year 3 since the allocated portion of adjusted tax basis ($800,000) is equal to the balance of the non-recourse loan. (Note: the remaining balance of the adjusted tax basis of $50,000 is allocated to the recourse loan. There is no minimum gain since the loan is recourse.)*

Assuming the non-recourse loan is subordinate in priority to the recourse loan, the adjusted tax basis of $850,000 is first allocated to the balance of the recourse loan, which is $150,000. The remaining adjusted tax basis of $700,000 is allocated to the $800,000 non-recourse loan. Thus, the partnership minimum gain at the end of year 3 is $100,000 ($800,000 - 700,000). [See Treas. Reg. § 1.704-2(m), Ex. (1)(v)]

3072 PARTNERSHIP MINIMUM GAIN IF BOOK/TAX DISPARITY

If partnership property subject to one or more non-recourse liabilities is reflected on the books of the partnership at a value that differs from its adjusted tax basis, the determination of partnership minimum gain in this section is based on the property's book value. [Treas. Reg. § 1.704-2(d)(3)]

The disparity between tax/book is due to property being contributed to the partnership (See PTM 1420), being re-valued (See PTM 1450), or a restatement of capital accounts (See PTM 1560).

See Example at PTM 3120 for illustration.

3073 SPECIAL RULE FOR YEAR OF REVALUATION

If the partners' capital accounts are increased pursuant to property being contributed to the partnership (See PTM 1420), being revalued (See PTM 1450), or a restatement of capital accounts (See PTM 1560) to reflect a revaluation of partnership property subject to a non-recourse liability, the net increase or decrease in partnership minimum gain for the partnership taxable year of revaluation is determined by:

1. First, calculating the net decrease or increase in partnership minimum gain using the current year's book values and the prior year's partnership minimum gain amount; and
2. Then adding back any decrease in minimum gain arising solely from the revaluation. [Treas. Reg. § 1.704-2(d)(4)]

See Example at PTM 3120.

If the partners' capital accounts are decreased to reflect a revaluation, the net decrease or increase in partnership minimum gain are determined in the same manner as in the year before the revaluation, but by using book values rather than adjusted tax bases. Note that the fair market value of the re-valued property cannot be less than the outstanding non-recourse liability secured by such property. (See PTM 1450)

3100 SHARES OF PARTNERSHIP MINIMUM GAIN

3110 General Rule

A partner's share of partnership minimum gain at the end of any taxable year equals:

The sum of

- *non-recourse deductions* allocated to that partner (and to that partner's predecessors in interest) up to that time and
- the *distributions* made to that partner (and to that partner's predecessors in interest) up to that time *of proceeds of a non-recourse liability allocable to an increase in partnership minimum gain* (See PTM 3120);

Minus the sum of

- that partner's (and to that partner's predecessors in interest) aggregate share of the net *decreases in partnership minimum gain* plus
- their aggregate share of decreases resulting *from revaluation of partnership property* subject to one or more partnership non-recourse liabilities. [Treas. Reg. § 1.704-2(g)(1)]

See examples at treasury regulation § 1.704-2(m)(1)(i) and (3)(i).

Important Rule: For purposes of § 1.704-1(b)(2)(ii)(d) (Alternative economic effect requirements, see PTM 1140), <u>a partner's share of partnership minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner's capital account that the partner is obligated to restore</u>. [Treas. Reg. § 1.704-2(g)(1)(ii)]

***Example**: See Example at* PTM 3070 *and the following additional discussion:*

The allocation of the non-recourse deductions in year 3 causes Laurie and Gary's capital accounts to be negative as follows:

	Laurie	***Gary***
Capital account at end of yr. 2	*$2,700*	*$300*
Less: net loss in year 3 (without non-recourse deductions.)	*(1,350)*	*(150)*
Less: yr. 3 Non-recourse deductions	*(6,300)*	*(700)*
Capital accounts at end of yr. 3	*($4,950)*	*($550)*

*The allocation of $6,300 in non-recourse deductions to Laurie increases her share of partnership minimum gain by $6,300. Under the rule discussed immediately above, (*a partner's share of partnership minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner's capital account that the partner is obligated to restore) *Laurie is treated as obligated to restore a deficit capital account balance up to $6,300, her share of the partnership minimum gain.*

Why is the above requirement necessary? Note that pursuant to the partnership agreement, Laurie, a limited partner, is ***not*** *required to restore her deficit capital account. Thus, under the economic effect test, the above allocation that reduces her capital account negative does not have economic effect. Though the partnership agreement contains a qualified income offset statement under the alternative economic effect test (*See PTM 1140*), an allocation cannot increase a deficit balance in Laurie's capital account. Thus, the only way for the allocation of $6,300 in non-recourse deductions (which causes Laurie's capital account to be negative) to have economic effect is that Laurie has to be obligated to restore a limited dollar amount up to such allocation. As a result, the allocation is considered to have economic effect under the alternative economic effect test contained in § 1.704-1(b)(2)(ii)(d)). [See Treas. Reg. § 1.704-2(m), Ex. (1)(i).]*

From an economic standpoint, this rule makes sense since if Laurie benefits from a tax deduction of $6,300, she should bear the economic burden of such deduction through the deficit restoration obligation.

Also, since Laurie is required to restore a deficit capital account balance up to $6,300 while her actual capital account balance at the end of year 3 is only -$4,950, she may be allocated up to an additional $1,350 of partnership deductions and losses that are ***not*** *non-recourse deductions in year 4.*

3120 Share of Net Decrease

A partner's share of the net decrease in partnership minimum gain is the amount of the total net decrease multiplied by the partner's percentage share of the partnership minimum gain at the end of the immediately preceding taxable year.

If there is a revaluation of the partnership property, a partner's share of any decrease in partnership minimum gain equals the increase in partner's capital account attributable to the revaluation to the extent the reduction in minimum gain is caused by the revaluation.

Example 1*: Linda and George form a limited partnership to acquire and lease a 5-year recovery property. Linda, the limited partner, and George, the general partner, contribute $10,000 each to the partnership. The partnership obtains an $80,000 non-recourse loan and purchases a machine for $100,000. The non-recourse liability is secured by the machine. Payments on principal of the loan are made $5,000 in each of the partnership first five years and the remaining balance of $55,000 is paid on the first day of year 6. The partnership agreement contains all the requirements discussed at* PTM 3030 *and except to satisfy the qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated equally between Linda and George, all distributions, except liquidating distribution, will be made equally between the two.*

In the partnership first taxable year, it generates rental income of $13,000, interest expense of $8,000, and a depreciation deduction of $15,000, resulting in a taxable loss of $10,000. In addition, the partnership repays $5,000 of the $80,000 debt. The allocation of the $10,000 loss equally between Linda and George has substantial economic effect. Their capital accounts at the end of the first year are as follows:

	Linda	***George***
Capital account on formation	*$10,000*	*$10,000*
Less: net loss in year 1	*(5,000)*	*(5,000)*
Capital account at end of year 2	*$5,000*	*$5,000*

Note: There is no partnership minimum gain at the end of year 1 since the balance of the loan $75,000 ($80,000 original balance less payment of $5,000) does not exceed the property's adjusted tax basis $85,000 ($100,000 original basis less depreciation of $15,000). Thus, there is no non-recourse deduction.

In the second year, the partnership generates rental income of $13,000, interest expense of $7,500, and depreciation of $22,000, resulting in a taxable loss of $16,500. In addition, the partnership repays $5,000 of the loan, and distributes $250 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the non-recourse loan at the end of that year, it would realize $7,000 gain ($70,000 outstanding loan balance less $63,000 adjusted tax basis). Thus, the amount of partnership minimum gain at the end of year two is $7,000, which is also the amount of non-recourse deductions for the year. As a result, the total partnership loss for the year ($16,500) consists of $7,000 of non-recourse deductions and $9,500 of loss without non-recourse deductions. The allocation of these items is as follows:

	Linda	***George***
Capital account at end of year 1	*$5,000*	*$5,000*
Less: net loss in year 2 (without non-recourse deductions)	*(4,750)*	*(4,750)*
Less: non-recourse deductions	*(3,500)*	*(3,500)*
Less: distribution	*(250)*	*(250)*
Capital account at end of year 2	*($3,500)*	*($3,500)*

*The allocation of $9,500 net loss (without non-recourse deductions) equally between the two partners has substantial economic effect. The allocation of the $3,500 non-recourse deductions is deemed to be in accordance with the partners' interests in the partnership because the requirements of § 1.704-2(e) (*See PTM 3030*) are satisfied. Each partner's share of partnership minimum gain is $3,500 and is obligated to restore their deficit capital account balances up to that amount pursuant to § 1.704-2(g)(2) (*See PTM 3100 *there is no example).*

If the partnership were to dispose of the property at the beginning of the third year in full satisfaction of the non-recourse loan, and assuming there is no other economic activity in that year, the partnership minimum gain would be decreased from $7,000 to zero. Linda and George's share of the decrease in minimum gain would be $3,500 each. Upon that disposition, the minimum gain chargeback would require that Linda and George each be allocated $3,500 of that gain before any other allocation is made under § 704(b). [See Treas. Reg. § 1.704-2(m), Ex. (3)(i)]

***Observation**: Thus, from an audit standpoint, the purposes of the determination of the non-recourse deductions are (1) to verify if the non-recourse deductions are allocated correctly pursuant to the requirements (discussed at *PTM 3030*) and (2) to make sure that the partners who are allocated these deductions are also allocated gains under the minimum gain chargeback rules (*See PTM 3150*)*

If the disposition of the property does not generate enough income to allocate under the minimum gain chargeback rules, a pro rata portion of the partnership's other items of income and gains for that year must be allocated to the partners (see ordering rules at PTM 3300, PTM 3340*). Therefore, it appears the allocations under the minimum gain chargeback rules precede the* § *704(b) allocations.*

Example 2*: Assume the same facts as in Example 1 except Carol is admitted to the partnership at the beginning of year three. At the time of Carol's admission, the fair market value of the machinery is $90,000 (the adjusted tax basis is $63,000). Carol contributes $10,000 cash in exchange for one-third interest in the partnership. The partnership purchases a piece of undeveloped land for $9,500 and holds the remaining $500 cash. Due to Carol's admission, the partnership revalues its property. The machinery's fair market value of $90,000 is reflected on the partnership's books. Pursuant to § 1.704-1(b)(2)(iv)(f) (*See PTM 1450*), the capital accounts of Linda and George are adjusted upward to $13,500 each to reflect the revaluation of the property. The adjustment reflects the manner the gain of $27,000 ($90,000 fair market value less $63,000 adjusted tax basis) would be shared between Linda and George if the machine were sold for its fair market value immediately prior to Carol's admission.*

	Linda	***George***
Capital account at end of year 2	*($3,500)*	*($3,500)*
Deemed sale adjustment	*13,500*	*13,500*
Capital accounts after Carol's admission	*$10,000*	*$10,000*

Note that prior to Carol's admission, there is no difference between Linda's and George's tax-basis capital accounts and book-basis capital accounts. After Carol's admission, Linda's and George's tax basis capital accounts remain the same as prior to the admission but their book basis capital accounts are adjusted upward to $10,000. (The book capital accounts are frequently shown on the partnership tax return.)

As a result of Carol's admission, the partnership agreement is modified to provide that except as otherwise required by its qualified income offset and minimum gain chargeback provisions, partnership income, gain, loss, and deductions, as computed for book purposes, are allocated equally among the partners, and those allocations are reflected in the partners' capital accounts. The partnership agreement also is modified to provide that depreciation and gain or loss, as computed for tax purposes, with regard to the machinery, will be shared among the partners in a manner that takes account for the variation *between the property's $63,000 adjusted tax basis and its $90,000 book value, pursuant to § 1.704-1(b)(2)(iv)(f) and § 1.704-1(b)(4)(i) (*See PTM 1450*).*

Effects of the revaluation: Due to the valuation of the machine upward by $27,000, the partnership minimum gain in year three is zero. (Note that since the book value of the machine is $90,000, there is no minimum gain because the balance of the loan is $70,000. Note also that if the property's adjusted tax basis is different from its book basis, the book basis is to be used to compute the partnership minimum gain. See PTM 3072*) Under the rule for computation of the partnership minimum gain in the year of revaluation (*See PTM 3073*), the net increase or decrease in partnership minimum gain in year three regarding the revaluation is computed as follows:*

First, calculating the net increase or decrease in partnership minimum gain using the current year book value and the prior year partnership minimum gain: the current year minimum gain is zero; the prior year minimum gain is $7,000. Thus there is a net <u>decrease</u> in partnership minimum gain of $7,000.

*Second, adding back any decrease in minimum gain arising solely from the revaluation. In this example, the decrease caused by the revaluation is $7,000. Thus, by adding back the $7,000 decrease in minimum gain arising solely from the revaluation, there is no net increase or decrease solely on account of the revaluation. (In other words, the partnership minimum gain is immediately reduced to zero before such revaluation and is immediately increased from zero to $7,000.) Thus, no minimum gain chargeback is triggered (*See PTM 3150*).*

All future non-recourse deductions will be computed based on the book value of the machinery and allocated to all three partners in accordance with the partnership agreement. Linda's and George's share of the decrease in minimum gain is $3,500 each. However, under the principles of § 704(c) (see PTM 1300*), the tax basis capital accounts of Linda and George will eventually be charged $3,500 each (due to the operation of § 704(c)), reflecting their 50 percent share of the decrease in partnership minimum gain, as illustrated in Example 3.*

***Example 3**: Assume the same facts as in Example 2 except during the partnership's third taxable year, the partnership generates rental income of $13,000, interest expense of $7,000, tax depreciation of $21,000, and book depreciation of $30,000. As a result, the partnership has a taxable loss of $15,000 and a book loss of $24,000. In addition, the partnership repays $5,000 of the non-recourse debt (after the date of Carol's admission). Thus, the balance of the non-recourse debt is $65,000. The partnership also distributes $500 cash to each partner.*

***Allocations**: If the partnership were to dispose of the property in full satisfaction of the non-recourse debt at the end of the year, the book gain would be $5,000 ($65,000 amount realized less $60,000 book basis). Thus, the partnership minimum gain is $5,000, which represents the decrease in partnership minimum gain of $2,000 (from $7,000 in year two). However, as discussed in Example 2, pursuant to the special rule for the year of revaluation, the net increase in partnership minimum gain in year three is determined by adding back the $7,000 decrease in minimum gain attributable to the revaluation of the machinery to the $2,000 net decrease in partnership minimum gain during the year. Thus, instead of a $2,000 decrease in minimum gain, there is a $5,000 increase ($7,000 - 2,000) in minimum gain in year three. Thus, the non-recourse deductions in year three are $5,000. Pursuant to the partnership agreement, all partnership items comprising of the book loss of $24,000, including the $5,000 non-recourse deduction, are allocated equally among the three partners. The allocation of these items, other than the non-recourse deductions, has substantial economic effect. With regard to the $21,000 depreciation for tax purposes, it is allocated in accordance with the principles of § 704(c): Linda and George are allocated $5,500 each; Carol is allocated $10,000.. Their tax and book capital accounts are as follows:*

	Linda/George		***Carol***	
	Tax	*Book*	*Tax*	*Book*
Capital account - yr. 3	*($3,500)*	*$10,000*	*$10,000*	*$10,000*
Less: Non-recourse deduction	*(916)*	*(1,666)*	*(1,666*	*(1,666)*
Less: Items other n/r deductions.	*(2,584*	*(6,334*	*(6,334)*	*(6,334)*
Less: Distribution	*(500)*	*(500*	*(500)*	*(500)*
Capital accounts - end of the yr.	*($70,000)*	*$15,000*	*$15,000*	*$15,000*

The capital accounts of Linda and George are similar. Their tax and book capital accounts are different due to the difference between the book value and the adjusted tax basis of the partnership property when Carol is admitted into the partnership. The computation of the above amounts is as follows:

***Allocation of Book Loss**: The partnership's book loss is $24,000. Under the partnership agreement, the book loss is share equally among the partners. Thus, each is allocated $8,000 of the book loss.*
***Allocation of tax loss**: The partnership's tax loss is $15,000. Included in this tax loss is tax depreciation of $21,000. Thus, the operating income without*

*depreciation is $6,000. Under the general rule of § 704(b), allocations of tax loss follow allocation of book loss, which, in this example, is also allocated equally among the three partners. However, when Carol is admitted into the partnership, the property's adjusted tax basis ($63,000) is different from its book value ($90,000). Thus, under the principles of § 704(c) regulations, the book/tax variation must be taken into consideration in allocating partnership taxable income, gain, loss, and deduction (*See PTM 2130*). Under the traditional method of allocation (*See PTM 2200*), tax allocation of depreciation must equal book allocation, subject to the ceiling rule. In this example, Carol, the "non-contributing partner"[16] is allocated one third of the total book depreciation, which is $10,000. Thus, for tax purposes, she must also be allocated $10,000 of tax depreciation. As a result, Linda and George are allocated the remaining tax depreciation of $11,000 ($21,000 total tax depreciation less $10,000 allocated to Carol). The partnership's income before tax depreciation is $6,000 and this income is allocated equally among the three partners (note that the § 704(c) allocation applies to § 704(c) property only). Each partner's share of the partnership's taxable loss in year 3 is as follows:*

	Linda	**George**	**Carol**
Income before depr.	*$2,000*	*$2,000*	*$2,000*
Less; depreciation	*(5,500)*	*(5,500)*	*(10,000)*
Taxable Loss	*($3,500)*	*($3,500)*	*($8,000)*

Allocation of Non-recourse Deductions*: the total non-recourse deduction for year three is $5,000 that is allocated equally among the three partners ($1,666 to each). This allocation is deemed to be in accordance with the partners' interest in the partnership. (*See PTM 3030*). For purposes of the tax capital accounts, the amount of tax non-recourse deduction is computed by multiplying the total tax depreciation by the ratio of the book non-recourse deductions ($5,000) to the total book depreciation ($30,000)-1[7] Thus, the tax non-recourse deduction is $3,500 ($21,000 x (5,000 ÷ 30,000)). For tax purposes, Carol is allocated an amount of non-recourse deduction equal to the book amount ($1,666). The balance of $1,834 ($3,500 - 1,666) is shared equally between Linda and George. The amount of "items without non-recourse deduction" is computed by subtracting the non-recourse deduction from the total taxable loss (i.e., $2,584 for Linda and George and $6,334 for Carol).*

Observation*: This example illustrates the coordination between the principles of the non-recourse deduction allocation and of § 704(c), and the general principle of § 704(b) that tax allocations must follow economic arrangement (or book allocations). Though the computation may appear complicated, the auditor should take time to redo the example to understand how these amounts are* *computed. Also, the examples provided in the regulations are good illustrations of the application of these allocation principles.[See §1.704(-2(m), Ex. (3)(iv) & (v).]*

3130 Conversion of Debt into Non-recourse Debt

A **recourse** liability or **partner non-recourse** liability may become partially or wholly **non-recourse** due to refinancing, the lapse of a guarantee, or other change to a debt instrument.

If a recourse liability becomes a non-recourse liability, a partner has a share of the partnership minimum gain that results from the conversion equal to the partner's deficit capital account (determined under § 1.704-1(b)(2)(iv)) to the extent the partner no longer bears the economic burden for the entire deficit capital account as a result of the conversion. For purposes of determining the extent to which a partner bears the economic burden for a deficit capital account, see the rule described in § 1.704-1(b)(2)(iii)(c). [Treas. Reg. § 1.704-2(g)(3)]

If a *partner non-recourse debt* becomes a *non-recourse debt*, the partner's share of the partnership minimum gain is increased to the extent the partner is not subject to the minimum gain chargeback requirement under § 1.704-2(i)(4) (See PTM 3150)

For definition of partner non-recourse debt, See PTM 3210.

3140 Distribution of Non-recourse Liability Proceeds

General Rules: If during its taxable year, a partnership makes a distribution to the partners which is <u>allocable to the proceeds of a non-recourse liability</u>, the distribution is allocable to an increase in partnership minimum gain to the extent the increase results from encumbering partnership property with aggregate non-recourse liabilities that exceed the property's adjusted tax basis. If the net increase in partnership minimum gain for a partnership taxable year is allocable to more than one non-recourse liability, the net increase is allocated among the liabilities in proportion to the amount each liability contributed to the increase in minimum gain. [Treas. Reg. § 1.704-2(h)(1)]

For illustration, see § 1.704-2(m), Ex. 1(vi).

PTM 3141 Distribution Allocable to Non-recourse Liability Proceeds
PTM 3142 Obligation to Restore
PTM 3143 Carryover

3141 Distribution Allocable to Non-recourse Liability Proceeds

A partnership may use any reasonable method to determine whether a distribution by the partnership to one or more partners is allocable to proceeds of a non-recourse liability. For instance, the rules prescribed under § 1-163-8T for allocating debt proceeds among expenditures constitutes a reasonable method. [Treas. Reg. § 1.704-2(h)(2)]

3142 Obligation to Restore

A partnership may treat any distribution to a partner of the proceeds of a non-recourse liability (that would otherwise be allocable to an increase in partnership minimum gain) as a distribution that is not allocable to an increase in partnership minimum gain to the extent the distribution does not cause or increase a deficit balance in the partner's capital account that exceeds the amount the partner is otherwise obligated to restore (within the meaning of § 1.704-1(b)(2)(ii)(c)) as of the end of the partnership taxable year in which the distribution occurs. [Treas. Reg. § 1.704-2(h)(3)]

3143 Carryover

The carryover rule applies if the net increase in partnership minimum gain for a partnership taxable year that is allocable to a non-recourse liability exceeds the distributions allocable to proceeds of the liability ("excess allocable amount"), and all or part of the net increase in partnership minimum gain for the year is carried over as an increase in partnership minimum gain for the immediately succeeding taxable year. The excess allocable amount is treated in the succeeding taxable year as an increase in partnership minimum gain that arose in that year as a result of incurring the non-recourse liability to which the excess allocable amount is attributable. [Treas. Reg. § 1.704-2(h)(4)]

For illustration, see § 1.704-2(m), Ex. 1(vi).

3150 Minimum Gain Chargeback Requirement

General rule: If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain as computed in PTM 3120. [Treas. Reg. § 1.704-2(f)(1)]

3151 Allocation of Minimum Gain Chargeback

Allocation of gain attributable to a decrease in partnership minimum gain (referred to a "minimum gain chargeback", see PTM 3100) must be made to the partners that either were allocated non-recourse deductions or received deductions of proceeds attributable to a non-recourse borrowing. [Treas. Reg. § 1.704-2(f)(1)]

3152 Exception for Conversion and Refinancing

A partner is **not** subject to the minimum gain chargeback requirement to the extent (1) the partner's share of the net decrease in partnership minimum gain is caused by a guarantee, refinancing, or other change in the debt instrument causing it to become partially or wholly recourse debt or partner non-recourse debt, and (2) the partner bears the economic risk of loss for the newly guaranteed, refinanced, or otherwise changed liability. [Treas. Reg. § 1.704-2(f)(2)]

***Example**: Tony and Jenny form a partnership, each contributes $2,500 to the partnership and agree to share all losses and profit equally. Neither of the partners is required to restore their deficit capital account balances. All the requirements regarding allocations of non-recourse liabilities are met (*See PTM 3030*). The partnership obtains a $10,000 non-recourse loan from an unrelated party and purchases two assets: stocks for $5,000 and depreciable property for $10,000. The non-recourse loan is secured by the depreciable property. The partnership generates $2,000 of depreciation in each of its first 5 years and that is its only tax item. These deductions are properly treated as non-recourse deductions and the allocation of these deductions is deemed to be in accordance with the partners' interests in the partnership. At the end of year 5, each partner has a deficit capital account of $2,500 and a $5,000 share of the partnership minimum gain. In the beginning of year 6, due to the lender's request, Tony guarantees the entire non-recourse liability. Pursuant to § 1.704-2(d)(1) (discussed at* PTM 3060*), the conversion of the non-recourse liability into recourse causes a net decrease in minimum gain of $10,000 and under § 1.704-*

*2(g)(2) (*See PTM 3130*), Tony and Jenny's share of that net decrease are $5,000 each. Under the minimum gain chargeback requirement, Jenny is subject to $5,000 minimum gain chargeback. Because the partnership does not have income in year 6, the entire $5,000 is carried over to succeeding taxable years until there is enough income to cover the minimum gain chargeback requirement. Under the exception discussed above, Tony is not subject to a minimum gain chargeback because he bears the economic risk of loss for the liability. Tony's share of "partner non-recourse debt minimum gain" is $5,000 under § 1.704-2(i)(3).*

*In year 7, the partnership earns $10,000 of net operating income and uses the money to repay the entire non-recourse liability that Tony guaranteed. Under § 1.704-2(i)(3), the partnership has a net decrease in partner non-recourse debt minimum gain of $5,000. Jenny must be allocated $5,000 of the operating income pursuant to the carried over minimum gain chargeback requirement. Under § 1.704-2(i)(4), Tony is allocated the other $5,000 of operating income as a partner non-recourse minimum gain chargeback. (*See PTM 3150*)*

3153 Exception for Capital Contributions

A partner is not subject to the minimum gain chargeback requirement to the extent the partner contributes capital to the partnership that is used to repay the non-recourse liability or is used to increase the basis of the property subject to the non-recourse liability, and the partner's share of the net decrease in partnership minimum gain results from the repayment of the increase to the property's basis. [Treas. Reg. § 1.704-2(f)(3)

3154 Waiver for Income Allocations

In any taxable year that a partnership has a net decrease in partnership minimum gain, if the minimum gain chargeback requirement would cause a distortion in the economic arrangement among the partners and it is **not** expected that the partnership will have sufficient other income to correct that distortion, the Commissioner has the discretion, if requested by the partnership, to waive the minimum gain chargeback requirement. The conditions for such a waiver request is provided in § 1.704-2(f)(4). The Commissioner may also provide additional exceptions through revenue rulings. [Treas. Reg. § 1.704-2(f)(4) & (5)]

***Example**: Partnership LG consists of two partners: limited partner L, and general partner G. L contributes $9,000 and G contributes $1,000 to the partnership. The partnership agreement has a minimum gain chargeback provision and provides that except as otherwise required by § 704(c), all losses* *will be allocated 90 percent to L and 10 percent to G; and that all income will be allocated first to restore previous losses and thereafter shared equally between L and G. Distributions are made first to return initial capital to the partners and then shared equally between the two partners. Final distributions are made in accordance with the partners' capital account balances. The partnership borrows $20,000 on a non-recourse basis from an unrelated party and purchases an asset for $30,000. The partnership's only tax item for each of the first three taxable years is $10,000 of depreciation on the asset. L's and G's share of minimum gain (for computation,* see PTM 3072*) and deficit capital account balances are $18,000 and $2,000 respectively at the end of the third taxable year. In the fourth year, the partnership earns $40,000 of net operating income and allocates the first $30,000 to restore the previous losses ($27,000 to L and $3,000 to G); the last $10,000 is allocated equally between L and G. The partnership also distributes $20,000 of available cash the same year. The first $10,000 is to return the partners' initial capital ($9,000 to L and $1,000 to G). The last $10,000 is distributed equally between L and G to reflect their ratio for sharing profit. Their capital accounts are as follows:*

	L	*G*
Capital account on formation	*$9,000*	*$1,000*
Less: net losses in yr. 1 - 3	*(27,000)*	*(3,000)*
Capital accounts at end of yr. 3	*(18,000)*	*(2,000)*
Allocation of income to restore non-recourse deductions	*$18,000*	*$2,000*
Allocation of operating income to restore cap. Contr.	*9,000*	*1,000*
Allocation of operating income to reflect profit	*5,000*	*5,000*
Capital accounts after allocations of income	*$14,000*	*$6,000*
Distribution reflecting capital contribution	*(9,000)*	*(1,000)*
Distribution in profit sharing ratio (50/50)	*(5,000)*	*(5,000)*
Capital account after distributions	*$0*	*$0*

In the fifth year, the partnership sells the property for $30,000 and realizes $30,000 gain. The proceeds are used to pay off the $20,000 non-recourse debt. The partnership has total cash of $30,000 ($20,000 cash left from year 4 after distribution of $20,000 of its total income of $40,000) to distribute and the partners expect to share it equally. However, without a waiver discussed above, the minimum gain chargeback would require the partnership to allocate the first $20,000 of the gain $18,000 to L and $2,000 to G, which would distort their economic arrangement. This allocation, together with the allocation of the remaining $10,000 profit $5,000 to each, would result in L having a positive capital account balance of $23,000 and G having a positive capital account *balance of $7,000. In effect, the allocation of $40,000 income in year 4 anticipated the minimum gain chargeback that did not occur until year 5. Assuming the partnership does not have sufficient other income to correct the distortion that would otherwise result, the partnership may request that the Commissioner exercise her discretion to waive the minimum gain chargeback requirement and recognize allocation that would allow L and G to share equally the $30,000 gain on the sale of the property. This allocation may be permitted by the Commissioner as discussed above.*

Observation: *Note that in this example, the application of the minimum gain chargeback requirement in year 5 becomes a distortion because the partnership already allocated the $40,000 income in year 4 in a manner that reduces the deficit balances caused by the allocation of non-recourse deductions in the previous three years. Thus, the $30,000 income realized by the partnership in year 5 should be allocated equally between the two partners as they agreed to share the economic benefit equally after all prior losses are offset and initial capital is returned through distribution. Assuming there was no income in year 4, the gain in year 5 would have to be allocated pursuant to the minimum gain chargeback requirement.*

3155 Items Subject to Minimum Gain Chargeback Requirement

Any minimum gain chargeback required for a partnership taxable year consists first of certain gains recognized from the disposition of partnership property subject to one or more partnership non-recourse liabilities and then if necessary consists of a pro rata portion of the partnership‘s other items of income and gain for that year. If the amount of the minimum gain chargeback requirement exceeds the partnership’s income and gains for the taxable year, the excess carries over. [Treas. Reg. § 1.704-2(f)(6)]

3200 PARTNER NON-RECOURSE LIABILITIES

A non-recourse liability is defined as a liability for which no partner or related person bears the economic risk of loss. (See PTM 3072). However, if the non-recourse liability is made by a partner or a related person, the non-recourse liability is treated as a partner non-recourse liability. (See PTM 3220)

In general, since none of the partners bears the economic risk of loss regarding non-recourse liabilities, the regulations provide rules for allocating deductions attributable to these liabilities based on the concepts of minimum gain, minimum gain chargeback, etc. However, when one or more than one partner bears the economic risk of loss with regard to a non-recourse liability, the non-recourse liability becomes that partner's non-recourse liability and the allocation rules regarding non-recourse liability generally apply to the partners who bears the economic risk of loss.

3210 Definition

A "partner non-recourse liability" means any partnership liability:

- to the extent the liability is non-recourse for purposes of treasury regulations §1-1001.2 and
- a partner or related person bears the economic risk of loss because the partner or the related person is the creditor or the guarantor. [Treas. Reg. § 1.704-2(b)(4)]

Treasury Regulation § 1-1001.2 does not provide a definition of non-recourse liability, but its examples refer to a non-recourse liability as the liability for which the borrower is "**not** personally liable on the note…" and in the event of default the creditor's "only recourse is to the asset". [Treas. Reg. § 1-1001-2(c), Ex. (2)]

3220 Non-recourse Deductions and Economic Risk of Loss

In general, partnership losses, deductions, or § 705(2)(a)(B) expenditures that are attributable to a particular partner non-recourse liability (referred to as "partner non-recourse deduction") must be allocated to the partner that bears the economic risk of loss for the liability.

If more than one partner bears the economic risk of loss for a partner non-recourse liability, the partner non-recourse deductions must be allocated among the partners according to the ratio in which they bear the economic risk of loss.

If partners bear the economic risk of loss for different portions of a liability, each portion is treated as a separate partner non-recourse liability. [Treas. Reg. § 1.704-2(i)(1)]

3230 Determination of Partner Non-recourse Deductions

For any partnership taxable year, the amount of partner non-recourse deductions with respect to a partner non-recourse debt equals:

- the net increase during the year in minimum gain attributable to the partner non-recourse debt (referred to as “partner non-recourse debt minimum gain”),
- reduced (but not below zero) by proceeds of a liability distributed during the year to the partner bearing the economic risk of loss for the liability. [Treas. Reg. § 1.704-2(i)(2)]

The determination of the following items with respect to the partner non-recourse liability are similar to the determination of the corresponding items with respect to the non-recourse liability:

- Partnership items constituting the partner non-recourse deductions (see PTM 3072)
- Partner non-recourse debt minimum gain and the share of this minimum gain (See PTM 3060) [Treas. Reg. § 1.704-2(i)(3)]
- Chargeback of partner non-recourse debt minimum gain (See PTM 3150) [Treas. Reg. § 1.704-2(i)(4)]
- Partner’s share of partner non-recourse debt minimum gain (See PTM 3100) [Treas. Reg. § 1.704-2(i)(5)]
- Distribution of partner non-recourse debt proceeds allocable to an increase in partner non-recourse debt minimum gain (See PTM 3140, PTM 3141) [Treas. Reg. § 1.704-2(i)(6)]

3300 ORDERING RULES

The following ordering rules are for determinations of:

- partner non-recourse deductions (PTM 3310),
- partnership non-recourse deductions (PTM 3320), and
- the minimum gain chargeback (PTM 3340).

Note: To help understand these rules, the auditor should bear in mind that many rules regarding partner non-recourse debt are similar to the corresponding rules regarding partnership non-recourse debt. For distinction between partner non-recourse debt and partnership non-recourse debt, see PTM 3030 & PTM 3220.

3310 Partner Non-recourse Deductions

Partnership losses, deductions, and § 705(a)(2)(B) expenditures are treated as partner non-recourse deductions in the following order:

1. First, depreciation or cost recovery deductions with respect to property that is subject to partner non-recourse debt;
2. Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and § 705(a)(2)(B) expenditures.
3. Depreciation or cost recovery deductions with respect to property that is subject to a partnership non-recourse liability is treated a partnership non-recourse deduction and any excess is treated as a partner non-recourse deduction. [Treas. Reg. § 1.704-2(j)(1)(i)]

3320 Partnership Non-recourse Deductions

The ordering rules are similar to the partner non-recourse deductions rules above except in item (1), property is the property subject to partnership non-recourse debt; and in item (3), depreciation on property subject to partner non-recourse liability is treated as partner non-recourse deduction first and the excess is treated as partnership non-recourse deduction. [Treas. Reg. § 1.704-2(j)(1)(ii)]

3330 Carryover

If the amount of non-recourse deductions or partner non-recourse deductions exceeds the partnership losses, deductions, and § 705(a)(2)(B) expenditures for the taxable year, the excess is treated as an increase in the partnership minimum gain or the partner non-recourse minimum gain in the immediately succeeding partnership taxable year. [Treas. Reg. § 1.704-2(j)(1)(iii)]

For illustration, see treasury regulation § 1.704-2(m), Ex. 1(vi).

3340 Minimum Gain Chargeback

Items of partnership income and gain equal to the minimum gain chargeback requirement (See PTM 3150) are allocated as a minimum gain chargeback in the following order:

- First, gain from the disposition of property subject to partnership non-recourse liabilities;

- Then, if necessary, a pro rata portion of the partnership's other items of income and gains for that year;

In case of chargeback regarding property subject to partner non-recourse debts, the same ordering rules as above apply, except that property is the one subject to partner non-recourse debt.

Gain from the disposition of property subject to partnership non-recourse debt is allocated to satisfy the partnership minimum gain chargeback requirement first. The excess is allocated to the partner non-recourse debt minimum gain chargeback.

Gain from the disposition of property subject to partner non-recourse debt is allocated to satisfy the partner minimum gain chargeback requirement first. The excess is allocated to the partnership non-recourse debt minimum gain chargeback. [Treas. Reg. § 1.704-2(j)(2)(i), (ii) and (iii)]

3400 TIERED PARTNERSHIPS

When a partnership ("upper tiered partnership") is a partner in another partnership ("lower tiered partnership"), the following rules apply:

- Increases in upper tiered partnership's minimum gain: If partnership A is a partner in partnership B, the sum of non-recourse deductions that B allocated to A and the distribution (of non-recourse proceeds) made by B to A during B's taxable year that are allocable to an increase in B's minimum gain, is treated as A's minimum gain. (The rule applies as if the upper tiered partnership were an individual partner.) [Treas. Reg. § 1.704-2(k)(1)]
- Decreases in upper tiered partnership's minimum gain: An upper tiered partnership's share of the lower tiered partnership's net decrease in minimum gain is treated as a decrease in the upper tiered partnership's minimum gain. [Treas. Reg. § 1.704-2(k)(2)]
- Non-recourse Debt proceeds distributed from the lower tiered partnership to upper tiered partnership are treated as proceeds of a non-recourse debt of the upper tiered partnership (provided that the non-recourse liability proceeds are allocable to an increase in the lower tiered partnership's minimum gain.) [Treas. Reg. § 1.704-2(k)(3)]
- All non-recourse deductions of lower tiered partnership are treated as depreciation by upper tiered partnership. [Treas. Reg. § 1.704-2(k)(4)]
- Coordination with partner non-recourse debt rules: If partnership A invests in partnership B and A or its related party is a guarantor or creditor of a non-recourse loan made to B, the rules regarding partner non-recourse loan apply to A as if A were an individual partner. [Treas. Reg. § 1.704-2(k)(5)]

3500 EFFECTIVE DATES

- In general, the rules discussed throughout the PTM 3000 series apply for partnership taxable years beginning on or after December 28, 1991. [Treas. Reg. § 1.704-2(l)(1)]

- A partnership may elect to apply the provisions of this section (i.e., the rules discussed throughout PTM 3000) to the first taxable year of the partnership ending on or after December 28, 1991 by attaching a written statement to the partnership return filed for the first taxable year ending on or after December 28, 1991. [Treas. Reg. § 1.704-2(l)(4)]

- For the rules applicable to partnership taxable years beginning after December 29, 1988, and before December 29, 1991, see former § 1.704-1T(b)(4)(iv). [Treas. Reg. § 1.704-2(l)(1)]

- For the rules applicable to taxable years beginning on or before December 28, 1988, see former § 1.704-1(b)(4)(iv). [Treas. Reg. § 1.704-2(l)(1)]

- For special rule applicable to pre-January 30, 1989 regarding related party of non-recourse debt, see § 1.704-2(l)(2).

- For transition rule for pre-March 1, 1984 regarding partner non-recourse debt, see § 1.704-2(l)(3).

4000 CONTRIBUTIONS TO PARTNERSHIPS

4010 GENERAL

Contributions to a partnership are somewhat common and therefore the determination of the tax ramification is important. Contributions are important from a compliance standpoint because:

Generally, a contribution of property is normally "tax free". There are several exceptions to the general rule. Gain or loss is recognized when:

- a partner receives a capital interest in a partnership for services (See PTM 4330);
- a partner receives a profits interest in a partnership for services (See PTM 4310);
- a partner acts in other than his capacity as a partner, in a transaction with the partnership (See PTM 4410, PTM 4420);
- encumbered property is contributed to a partnership (See PTM 4120);
- property is transferred to a partnership which would be treated as an investment company if it were a corporation (See PTM 4540);
- a partner contributes property and that property is distributed to another partner or a distribution of other property to the contributing partner. This transaction may be treated as a sale or exchange (See PTM 4500);
- a partner contributes property and receives a distribution of cash or property (See PTM 4420).

Basis of contributed property must be computed. (See PTM 4600)

4020 CALIFORNIA CONFORMITY

California generally conforms to IRC §721 through §724 with California Revenue and Taxation Code §17851 that makes contributions of property to partnerships tax free. There are exceptions to the general conformity rules that will be discussed at length in the corresponding sections.

4030 CONTRIBUTIONS OF CASH

The basis of a partner's interest in a partnership acquired by a contribution of only cash is the amount of cash contributed to the partnership. [IRC § 722, California Revenue & Taxation Code §17851] (See PTM 5030)

4040 DEFINITION OF PROPERTY

Although IRC §721 provides that a contribution of property in exchange for a partnership interest may be tax free, the Code does not define what constitutes "property" as it relates to this section. The regulations under §721 provide that property includes an installment obligation.

The following have been held to be "property" contributed to a partnership:

- a contractual right to participate in another partnership [Dillon v. United States, 84-2 USTC];
- long-term leasehold [Private Letter Ruling 8224069 (March 24, 1982)];
- limited partnership interests in a partnership which holds unrealized receivables [Rev. Ruling 84-115, 1984-2 CB 118];
- cash and third party demand notes. [IRS Letter Ruling 8117210]

For further discussions of what constitutes property, see "Federal Taxation of Partnerships", McKee, Nelson and Whitmire; ¶ 4.02[1]

4100 CONTRIBUTION OF PROPERTY

4110 Unencumbered Property—General

Generally, the contribution of unencumbered property is tax free to the partnership and the contributing partner. [IRC § 721(a), California Revenue and Taxation Code § 17851]

The partnership's basis in the property contributed by a partner is equal to the adjusted basis to the contributing partner at the time of contribution. [IRC § 723]

Partners may recognize gain on a transfer of appreciated property to a partnership that would be treated as an "investment company" (within the meaning of §351) if the partnership were incorporated. [IRC § 721(b)] (See PTM 4540)

- The recognition of gain on a transfer of appreciated property to a partnership investment company results in a "stepped up" basis for assets contributed. [IRC § 723]

4120 Contribution of Encumbered Property

The contribution of encumbered property to a partnership may result in a gain to the contributing partner. [IRC § 752(b). 731(a) and Treas. Reg. § 1.722-1]

A gain may result because the liability shifting creates a deemed distribution and contribution of cash between the partner and the partnership that are treated as cash transfers. [IRC §§ 752(b), 731(a)(1) and Treas. Reg. § 1.722-1]

When an asset transferred to a partnership is encumbered by a liability(ies), there is a shifting of the responsibility for payment from the partner who contributed the encumbered property to the partnership which now owns the property. This has two results:

- The shift in liability(ies) decreases the contributing partner's basis in his partnership interest [IRC §§ 752(b), 705(a)(2), 732, 733] and

increases the noncontributing partners' basis in their partnership interests.
- The shift in liabilities may require the contributing partner to report a gain even though the contribution of property was a nonrecognition transaction. [IRC §§ 752(b), 731(a); Treas. Reg. § 1.722-1]

For a discussion on Sharing of Liabilities; See PTM 5500.

PTM 4121 Property Encumbered with a Recourse Liability
PTM 4122 Property Encumbered with a Non-recourse Liability

4121 Property Encumbered with a Recourse Liability

A recourse liability is defined as a liability in which any one partner or person related to that partner bears the economic risk of loss for the liability. [Treas. Reg. § 1.752-1(a)(1) (See, PTM 5490)

The share of partnership recourse liabilities allocated to a partner equals that portion for which the partner **bears the economic risk of loss**. [Treas. Reg. § 1.752-2(a)] (See PTM 5500)

If the partnership assumes the liability of the contributed property, the portion of the liability allocated to other partners under IRC §752 is treated as a cash distribution from the partnership to the contributor. [IRC § 752(b)] (See, PTM 5500 and PTM 5200)

If the contribution of property affects the interests of the partners in partnership profits and loss, their share of the partnership liability may also change under IRC §752. If a partner's share of profits and losses decreases, for example, the partner is treated as receiving a cash distribution from the partnership subject to the distribution rules. (See, PTM 5200)

The contributing partners' basis has several adjustments when property encumbered by a recourse liability is contributed. They are as follow:
- First, the contributing partner's basis is increased by his adjusted basis in the contributed property [IRC § 722], any money contributed [IRC § 722], and the portion of any pre-existing partnership liabilities allocated to him as a result of any increase in partnership interest. [IRC §§ 722, 752(a)]
- The contributing partner's basis is decreased by (but not below zero) by the amount of his former liabilities that are allocated to the other partners

as a result of the partnership's assumption of the liabilities. [IRC § 752(b), § 733]
- If the portion of the contributor's liabilities allocated to other partners is in excess of his adjusted basis, the excess is a deemed distribution and is taxable to the contributing partner. [IRC § 731(a)(1), § 741, Treas. Reg. § 1.731-1(a)(3)]

The basis of the non-contributing partners in their partnership interest is adjusted as follows:
- Increased by his share of the contributing partner's liabilities that have been assumed by the partnership. [IRC § 752(a), § 722]
- Decreased by the portion of his share of pre-existing partnership liabilities that are reallocated to the contributing partner. [IRC § 752(b), § 733]
- If the deemed distribution resulting from the reduction of liabilities allocated to the non-contributing partner is greater than his adjusted basis in his partnership interest, taking into account all of the other adjustments, the excess is deemed distribution and taxable to the non-contributor. [IRC §§ 752(b), 731(a)(1); Treas. Reg. § 1.752-1(f)]

Example:
*A acquires a one third interest in a partnership by contributing land to ABC Partnership. At the time of the contribution, the land has a fair market value of $20,000, an adjusted basis to A of $10,000, and is encumbered by a **recourse** mortgage of $6,000 that is assumed by the partnership. B contributes $20,000 to the partnership for the remaining 2/3 interests in ABC. The partnership assumes the entire liability on the contributed property.*

A's individual liability is viewed as first decreasing by $6,000 and then increasing by $2,000(6,000x1/3). Only the net decrease is taken into account. [Treas. Reg. § 1.752-1(f)] B is considered as incurring a $4,000 increase in his share of partnership liabilities (6,000 x 2/3).

A and B's initial bases is computed as follows:

	A's basis	*B's Basis*
Contribution	*$10,000*	*20,000*
P/S Assumption of Liab.	*(6,000)*	*0*
Liability Share	*2,000*	*4,000*
Basis in ABC	*$6,000*	*$24,000*

The partnership's basis in the property is $10,000, which is the carryover basis.

4122 Property Encumbered with a Non-recourse Liability

If contributed property is subject only to "non-recourse" liabilities, the rules for allocating these liabilities among partners decreases the impact of §752(b) in the contribution context. A liability is non-recourse, for purposes of §752, if no partner or related person bears the economic risk of loss for the liability. [Treas. Reg. § 1.752-1(a)(2)] (See PTM 5492)

Generally, a partner contributing an asset encumbered by a non-recourse liability will not have a deemed distribution under IRC §752(b) that exceeds his basis in his partnership interest.

In general, Regulations §1.752-3(a) provides that a partner's share of partnership non-recourse liabilities is the sum of his interest in three tiers:

1. Tier 1 allocates the liability according to the amount of "minimum gain" that would be allocated to a partner under IRC §704(b). Partnership minimum gain is the excess of partnership non-recourse liabilities over the §704(b) "book" value of the partnership assets they encumber. [Treas. Reg. § 1.704-2(d)(3)] Generally there is no minimum gain created at the time of contribution when an asset is contributed to a partnership since the value of the contributed property is usually greater than the liabilities associated with the property. (See McKee, Nelson & Whitmire: *Federal Taxation of Partnerships and Partners*, Third Edition, ¶8.04[3])
2. 2. In tier 2, the partner is allocated an amount of partnership non-recourse liabilities equal to the gain that would be allocated to the partner under §704(c)(or in the same manner as §704(c) in connection with the revaluation of partnership property) if the partnership made a taxable disposition of all partnership property subject to non-recourse liabilities in exchange for no consideration other than relief of such non-recourse liabilities; [Allocations mandated by Treas. Reg. § 1.704-1(b)(2)(iv)(F)(4)]
3. In tier 3, a partner is allocated non-recourse liabilities in an amount equal to his share of “excess non-recourse liabilities,” which are liabilities that are not allocated in tiers 1 or 2.

The rationale for allocating liabilities in this manner is to coordinate the liability allocation rules with the income/loss recognition rules under IRC §§704(b) & (c). Liabilities whose recognition or relief would give rise to partnership income or gain would be allocated to the same partners to whom the income or gain would be allocated.

Example—Non-recourse liability in excess of basis of contributed property:

A contributes a piece of land to a limited partnership in exchange for a 20% limited partnership interest. At the time of contribution, A's basis in the land is $40,000, it is subject to a $80,000 non-recourse liability and has a value of $100,000. The partnership assumes the liability and has no other liabilities. There is no minimum gain amount since the book value is greater than the liability. The 704(c) minimum gain amount allocated to A is $40,000 ($80,000 liability less 40,000 adjusted basis in property). The remaining $40,000 of the non-recourse liability is allocated among the partners using their profit sharing ratio. A is allocated $8,000 (20% x 40,000). Therefore, A's share of the partnership's liabilities is $48,000 (40,000 + 8,000). Since the net decrease in A's share of the liability is $32,000 ($80,000 less 48,000) the deemed cash distribution is $32,000. [Treas. Reg. § 1.752-1(f)] Since the $32,000 net decrease does not exceed A's $40,000 basis in the property, A recognizes no gain on the contribution and has a basis in his partnership interest of $8,000 ($40,000 initial basis less 32,000 deemed distribution).

Note: For further discussion on non-recourse liabilities, see PTM 5700.

If the contributed property is depreciable, the §704(c) gain is reduced over time as the property is depreciated, and the non-recourse liabilities previously allocable to the contributor may become allocable (in whole or in part) to his partners.

4130 Character of Contributed Property

- IRC §724 precludes the use of partnership contributions as a vehicle for converting ordinary income property into capital gain property. In addition, §724(c) contains a special rule that prevents the conversion of built-in capital losses into ordinary losses upon contributions of property to partnerships.
- A contribution to a partnership of **unrealized receivables [**IRC § 751(c)] will cause the partnership to realize ordinary income upon any subsequent disposition (or collection) of the receivables, regardless of how long they are held. [IRC § 724(a)] The definition of unrealized receivables is determined by treating any reference to the partnership as referring to the partner. [IRC § 724(d)(1)]
- A contribution of property that is **inventory** in the hands of the contributing partner will result in ordinary income being realized by the partnership if the inventory is disposed of by the partnership within five years of the contribution. [IRC § 724(b)] Inventory is defined in IRC §751(d) and is determined by treating any reference to the partnership as referring to the partner and by applying §1231 without regard to any holding period.

- A contribution of property that would create a **capital loss** if sold by the contributing partner will produce capital loss treatment on the disposition of the property by the partnership within five years of the contribution to the extent of the built-in loss at the time of contribution. [IRC § 724(c)]

Example 1—Unrealized Receivable:
C, a cash method sole proprietor, bills a client for $10,000 for services rendered. The client has suffered financial difficulties and has not been able to pay C. C contributes the receivable to a partnership that invests in stock and bonds. At the time C contributes the receivable, it was worth $4,000. In exchange, C receives a 1/3 interest in the partnership. Six months later, the partnership collects the full $10,000 on the receivable. The partnership must characterize the full $10,000 gain as ordinary income even though it held the receivable as a capital asset.

Example 2—Capital Loss Property:
F, an investor in real estate, contributes a real estate investment (unimproved land) that he owned for six years to a partnership in exchange for an interest in that partnership. At the time of contribution, F's basis in the land was $70,000 and its value was $50,000. The partnership intends to build a strip mall on the land contributed by F, which converts the land to property used in a trade or business (§1231 property). After holding the property for another year, the partnership abandons its intent to build a strip mall on the property and sells it for $40,000, realizing a $30,000 loss. The partnership must characterize $20,000 ($70,000 basis less 50,000 value at the time of contribution) of the loss as capital. The remaining $10,000 loss is treated as §1231 loss with the potential for ordinary loss treatment by the partners.

4140 Depreciation of Contributed Property

- The general rule is that all depreciation deductions for an asset are determined by using the depreciation rules (method, life, salvage value, etc.) in effect at the time the taxpayer places that asset in service. [IRC § 168(i)(7)(A)]
- This rule applies whether legislation adopts a more or less favorable depreciation rule.
- When a partner contributes property to a partnership in a nonrecognition transaction, the contributor's basis and all other tax attributes inherent in the contributed property are transferred to the partnership. The partnership, in essence, steps into the shoes of the contributing partner. [IRC § 168(i)(7)(A)]
- If the property contributed to the partnership is personal use property, a partnership shall determine its annual depreciation deductions by using the

depreciation rules in effect on the date the property was converted to business use property. [Treas. Reg. § 1-168-2(j)(1)]

Example 1—Contribution of Property used in trade or business:
A purchased an office building for $4,000,000, of which $3,150,000 is attributable to the building, $850,000 is attributable to the land. For an office building placed in service in 1988, the recovery period is 31.5 years and the straight-line method of depreciation must be used. Therefore, A's annual depreciation deductions are $100,000 for the next 31.5 years. On January 1, 1998, A contributes the building to a partnership in exchange for an interest in that partnership. A's $3000,000 ($4,000,000 adjusted basis less $1,000,000 depreciation deductions) adjusted basis in the property is transferred to the partnership. The partnership continues to depreciate $100,000 annually for the next 21.5 years.

Example 2—Contribution of Personal Use Property
C purchased a condo in 1986 for $275,000, which she occupied as her personal residence. On January 2, 1992, C contributed the condo to a partnership in exchange for a partnership interest. The partnership converts the property to rental property. Residential rental property placed in service in 1992 uses a 27.5-year recovery period and the straight-line method of depreciation. The partnership is deemed to have placed the condo in service in 1992. Starting in 1992, the partnership can depreciate the property over the next 27.5 years. The depreciation deduction is $10,000 per year.

4200 ALLOCATION OF BUILT IN GAIN OR LOSS ON CONTRIBUTED PROPERTY

If a partner contributes property to a partnership which has a basis different from its value, the contributing partner must be allocated certain items of income, gain, loss and deduction with respect to the contributed property to take into account any difference between the fair market value and the adjusted basis of the contributed property. [IRC § 704(c)(1)(A)] Post contribution gain or loss is allocated to the partners according to their distributive share.

Property contributed to a partnership is **§704(c) property** if at the time of the contribution, the book value of the property differs from the contributing partner's adjusted tax basis in the property. The book value in this instance is equal to the fair market value at the time of contribution. [Treas. Reg. § 1.704-3(a)(3)] The "book value" is used for capital account purposes.

The purposes of these rules is to prevent partners from shifting the tax consequences with respect to unrealized gain on property to other partners by contributing the property to a partnership. [Treas. Reg. § 1.704-3(a)(1), effective 12/21/93]

Example:
M and K form an equal partnership. M contributes land with a basis of $50,000 and a value of $40,000. K contributes $40,000 in cash. Each has an initial ***capital account*** *balance of $40,000. During the partnership's first year, the land declines in value to $30,000 and the partnership sells it for that amount. Economically, the partnership's loss of $20,000 is attributable to a $10,000 decline in value that occurred while M was the owner and a $10,000 decline in value that took place while the property was held by the partnership. Therefore, $10,000 of the loss is allocable to M under IRC §704(c)(1)(A). The other $10,000 loss is allocable 50% to M and 50% to K. Therefore, M has a loss of $15,000 and K has a loss of $5,000 from this transaction.*

The **built in gain** on §704(c) property (defined above) is the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution. The built in gain is then reduced by decreases in the difference between the property's book value and adjusted tax basis. [Treas. Reg. § 1.704-3(a)(3)(ii)]

The built in loss on §704(c) property is the excess of the contributing partner's adjusted tax basis over the property's book value at the time of the contribution.

The built in loss is then reduced by decreases in the differences between the property's adjusted tax basis and book value. [Treas. Reg. § 1.704-3(a)(3)(ii)]

If a transaction is classified as a sale under IRC §707, then it is not to be considered a contribution of property to which IRC §704(c) applies. [Treas. Reg. § 1.704-3(a)(5)]

If a contributing partner **transfers** a partnership interest, the built in gain or loss associated with that property must be allocated to the transferee partner as it would have been allocated to the transferor partner. [Treas. Reg. § 1.704-3(a)(7)]

4210 Reasonable Methods of Allocation

If the basis of contributed property differs from its value, IRC §704(c)(1)(A) requires income, gain, loss and deduction with respect to the contributed property to be allocated among the partners so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

Allocations must be made using a reasonable method. These methods include:

- the traditional method (see PTM 4211),
- the traditional method with curative allocations (see PTM 4212),
- remedial allocation method (see PTM 4213), and
- other methods if reasonable.

An allocation method is not unreasonable simply because it results in lower aggregate tax liability. [Treas. Reg. § 1.704-3(a)(1)]

A partnership may use different methods of allocating gain/loss for different types of contributed property provided the partnership and partners consistently apply a single reasonable method for each item and the overall method or combination of methods is reasonable based on facts and circumstances. [Treas. Reg. § 1.704-3(a)(2)]

The allocation method used for an item must be consistently applied by both the partner and the partnership.[Treas. Reg. § 1.704-3(a)(2)]

It may be unreasonable to use one method for appreciated property and another method for depreciated property or to use the traditional method for a partner in a high tax bracket and use the curative allocation for a partner in a lower tax bracket. [Treas. Reg. § 1.704-3(a)(1)]

4211 Traditional Method

The traditional method requires that when a partnership has income, gain, or loss attributable to §704(c) (defined in PTM 4200), it must allocate to the contributing partner the built in gain or loss associated with the property to avoid shifting the tax consequences. [Treas. Reg. § 1.704-3(b)(1)]

For §704(c) property that is subject to depreciation, depletion or amortization, the allocation of deductions attributable to these items takes into account built in gain or loss on the property. For example, tax allocations to noncontributing partners of depreciation with respect to §704(c) property generally must equal book allocations to those partners. A noncontributing partner's share of the "book depreciation" would be equal to the amount of depreciation that would be allocable to him under the terms of the partnership agreement if the fair market value of the property at the time of contribution was depreciated under the income tax rules.

The **ceiling rule** prevents a partnership from making tax allocations to partners that exceed the total amount of the item to which the partnership is entitled for tax purposes. The ceiling rule limits the total amount of income, gain, loss or deduction that is allocated to the partners for a tax year with respect to a property to the total partnership income, gain, loss or deduction with respect to that property for the tax year. [Treas. Reg. § 1.704-3(b)(1)] For example, where the contributed property's tax basis is significantly lower than its fair market value, there may be insufficient partnership tax deductions or eventual gain on the sale of the property to eliminate the §704(c) variation in its entirety. Adherence to the ceiling rule may require a non-contributing partner to forgo some depreciation deductions on the contributed property.

Example 1--Allocation of built in gain:
A and B form partnership AB and agree that each will be allocated 50% of all partnership items and that AB will make the allocations under §704(c) using the traditional method. A contributes depreciable property with an adjusted tax basis of $4,000 and a book value (fair market value) of $10,000, and B contributes

$10,000 in cash. In accordance with Treas. Reg. §1.704-3(a)(3), A has a built in gain of $6,000 which is the excess of the partnership's book value ($10,000) over A's adjusted basis in the property ($4,000) at the time of the contribution. [Treas. Reg. § 1.704-3(b)(2)]

Example 2---Allocation of depreciation (using the above example):
*The piece of property is depreciated using the straight-line method over a ten-year recovery period. Because the property is depreciated at an annual rate of 10%, B would be entitled to a depreciation deduction of $500 for both book and tax purposes **if** the adjusted basis of the property equaled its fair market value at the time of contribution. Although each partner is allocated $500 (10% of 10,000 x 50%) of book depreciation per year, the partnership is allowed a tax depreciation deduction of $400 per year (10% of 4,000). The partnership can allocate only $400 of tax depreciation under the ceiling rule and it must be allocated entirely to B.*

At the end of AB's first year, the book value of the property is $9,000 (10,000 - 1,000 book depreciation) and the adjusted basis is $3,600 (4,000 - 400 tax depreciation). A's built in gain with respect to the property decreases to $5,400 ($9,000 book value less $3,600 adjusted tax basis). Also at the end of AB's first year, A has a $9,500 book capital account and a $4,000 tax basis in her partnership interest. B has a $9,500 capital account balance and a tax basis of $9,600 in his partnership interest. [Treas. Reg. § 1.704-3(b)(2)(ii)]

Example 3--- Sale of the Property:
If AB sells the property at the beginning of AB's second year for $9,000, AB realizes a tax gain of $5,400 ($9,000 amount realized less the adjusted tax basis of $3,600). The entire $5,400 gain must be allocated to A because the property A contributed has that much built in gain remaining.

If AB sells the property at beginning of AB's second year for $10,000, AB realizes a tax gain of $6,400 ($10,000 amount realized less $3,600, the adjusted basis). Only $5,400 gain must be allocated to A to account for A's built in gain. The remaining $1,000 is allocated equally between A and B in accordance with the partnership agreement. If AB sells the property for less than the $9,000 book value, AB realizes tax gain of less than $5,400 and the entire gain must be allocated to A.

Note: *For further discussion of the traditional method of allocation, see* PTM 2200. *For further examples, see Treasury Regulation §1.704-3(b)(2).*

4212 Traditional Method with Curative Allocations

The traditional method with curative allocations may be used to correct distortions created by the ceiling rule. The method will be used to reduce or eliminate disparities between book and tax items of noncontributing partners. [Treas. Reg. § 1.704-3(c)(1)]

A **curative allocation** is an allocation of income, gain, loss or deduction for tax purposes that differs from the partnership's allocation of the book item. An example is if a noncontributing partner is allocated less tax depreciation than book depreciation with respect to an item of §704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference. The corresponding book depreciation is allocated to the contributing partner. [Treas. Reg. § 1.704-3(c)(1)]

A partnership must consistently apply the application of curative allocations.[Treas. Reg. § 1.704-3(c)(2)]

A curative allocation must be reasonable. This means that curative allocations must:

- be reasonable in amount. They may be made only to the extent necessary to offset the effect of the ceiling rule for the tax year, or on the disposition of property, for prior tax years. [Treas. Reg. § 1.704-3(c)(3)(i)]
- be made over a reasonable period of time.
- be expected to have substantially the same effect on each partner's tax liability as the tax items limited by the ceiling rule.

Example of Reasonable Curative Allocations:
E and F form partnership EF and agree that each partner will be allocated a 50% share of all partnership items and then EF will make allocations using the traditional method with curative allocations. E contributes equipment with an adjusted tax basis of $4,000 and a book value (fair market value) of $10,000. The equipment has 10 years remaining on its depreciable life and is depreciated using the straight-line method. At the time of contribution, E has a built in gain of $6,000, and therefore, the equipment is § 704(c) property. F contributes $10,000 of cash, which EF uses buy inventory for sale to customers. In EF's first year, the operating revenue is equal to expenses. The equipment creates $1,000 of book depreciation and $400 of tax depreciation for each taxable year. At the end of the first year, EF sells the inventory for $10,700, recognizing $700 of income. The partners anticipate that the inventory income will have substantially the same effect on their tax liabilities as income from E's contributed equipment. Under the traditional method, E and F would each be allocated $350 of income from the

sale of inventory for book and tax purposes and $500 of depreciation for book purposes. The $400 of tax depreciation would be allocated to F. Thus, at the end of the first year, E and F's book and tax capital accounts would be as follows:

	E		*F*	
	Tax	*Book*	*Tax*	*Book*
Initial Contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Depreciation	*(500)*	*(0)*	*(500)*	*(400)*
Sales Income	*350*	*350*	*350*	*350*
Total	*$9,850*	*$4,350*	*$9,850*	*$9,950*

Reasonable curative allocation: Because the ceiling rule would cause a disparity of $100 between F's book and tax capital accounts, EF may properly allocate to E an additional $100 of income from the sale of inventory for tax purposes. This allocation results in capital accounts at the end of EF's first year as follows:

	E		*F*	
	Book	*Tax*	*Book*	*Tax*
Initial Contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Depreciation	*(500)*	*(0)*	*(500)*	*(400)*
Sales Income	*350*	*450*	*350*	*250*
Total	*$9,850*	*$4,450*	*$9,850*	*$9,850*

Unreasonable curative allocation: Assume the same facts as above except that E and F choose to allocate all the income from the sale of inventory to E for tax purposes, although they share it equally for book purposes. This allocation results in capital accounts at the end of EF's first year as follows:

	E		*F*	
	Book	*Tax*	*Book*	*Tax*
Initial Contribution	*$10,000*	*$4,000*	*$10,000*	*$10,000*
Depreciation	*(500)*	*(0)*	*(500)*	*(400)*
Sales Income	*350*	*700*	*350*	*0*
Total	*$9,850*	*$4,700*	*$9,850*	*$9,600*

This curative allocation is not reasonable because the allocation exceeds the amount necessary to eliminate the difference in amounts allocated to F's book and tax capital accounts. [Treas. Reg. § 1.704-3(c)(4) Example 1(iii)(B)]

Note: For further discussion and examples of reasonable curative allocations, See PTM 2230 or Treas. Reg. §1.704-3(c)(4) Example 1.

4213 Remedial Allocation Method

In order to eliminate ceiling rule disparities between tax items of noncontributing partners and corresponding book items, a partnership may use the remedial allocation method.

The partnership eliminates disparities by creating remedial items and allocating those items to its partners. [Treas. Reg. § 1.704-3(d)(1)]

Under the remedial allocation method, the partnership first determines the amount of book items (described below) and the partner's distributive shares of these items under IRC §704(b). The partnership then allocates the tax items recognized by the partnership using the traditional method. If the ceiling rule results in a book allocation of an item to a noncontributing partner that differs from the similar tax allocation of the item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss or deduction equal to the amount of the difference and allocates it to the noncontributing partner. The partnership then creates an offsetting remedial item in the same amount and allocates it to the contributing partner. [Treas. Reg. § 1.704-3(c)(2)]

A partnership determines the amount of book items attributable to the contributed property in the following manner:

> by recovering the portion of the partnership's book basis in the property equal to the adjusted tax basis in the property at the time of the contribution in the same manner as the adjusted tax basis is recovered and the remainder of the partnership's book basis in the property (the amount by which the book basis exceeds the adjusted tax basis) by using any applicable recovery period and depreciation method available for newly purchased property placed in service at the time of the contribution. [Treas. Reg. § 1.704-3(d)(2)]

Remedial allocations of income, gain, loss or deductions to the noncontributing partner must be of the same character as the tax item limited by the ceiling rule.

Example:
L and M form partnership LM and agree to allocate all items equally. The partnership agreement provides that allocations will be made using the remedial method and that straight-line depreciation will be used to recover excess book basis. L contributes depreciable property with a basis of $4,000 and a fair market value of $10,000. The property is depreciated using the straight-line

method with a ten-year recovery period and the property has a remaining four years on its depreciable life. M contributes $10,000 in cash. Except for its depreciation deductions, LM's expenses equal its income each year starting with the year the partnership was formed.

*Under the remedial allocation method, LM has book depreciation for each of its first four years of $1,600 ($1,000 related to the contributing partner's $4,000 basis which is depreciated over its remaining useful life of four years and $600 related to the $6,000 excess of book value over tax basis which is depreciated under a **new** ten year recovery period). Under the partnership agreement, L and M are each allocated 50% ($800) of this book depreciation. M is allocated $800 of tax depreciation and L is allocated the remaining $200 ($1,000 less 800) tax depreciation. No remedial allocations are being made because the ceiling rule does not result in a book allocation of depreciation that is different from the tax allocation. The allocations result in the following capital accounts at the end of LM's first four years:*

	L		M	
	Book	Tax	Book	Tax
Initial Contribution	10,000	4,000	10,000	10,000
Depreciation	(3,200)	(800)	(3,200)	3,200
Total	6,800	3,200	6,800	6,800

*For year 5-10, LM has $600 of **book** depreciation (6,000 excess of initial book value over adjusted tax basis divided by the ten year recovery period applicable to the excess), which is allocated to L and M equally. Under the ceiling rule, M would be allocated $300 of book depreciation, but no tax depreciation. Since the ceiling rule would cause an annual disparity of $300 between M's allocations of book and tax depreciation, LM allocate $300 of tax depreciation to M and allocate an offsetting remedial allocation to L of $300 of income, which must be of the same type as income produced by the property. At the end of the 5th year, LM's capital accounts are as follows: [Treas. Reg. § 1.704-3(d)(7), Example 1]*

	L		M	
	Book	Tax	Book	Tax
End of Year 4	6,800	3,200	6,800	6,800
Depreciation	(300)	0	(300)	0
Remedial Allocation	0	300	0	(300)
Total	$6,500	$3,500	$6,500	$6,500

***Note:** For further discussion and examples of remedial allocations, see* PTM 2400 *and Treas. Reg. §1.704-3(d).*

4220 Securities Partnerships

A partnership is a securities partnership if the partnership is either a management company or an investment partnership and the partnership makes book allocations in proportion to its book capital accounts. [Treas. Reg. § 1.704-3(e)(3)(iii)(B)(2)]

A securities partnership may revalue each of its financial assets every day, making tracking of separate basis adjustments for each of many securities impractical. [T.D. 8500, December 21, 1993]

A securities partnership may use any reasonable approach to aggregate gains and losses from qualified financial assets that is consistent with the purpose of IRC §704(c), but once it adopts an approach, it must continue to use it.

The regulations describe two reasonable methods for allocating gains and losses:

- partial netting approach
- full netting approach.

Under the partial netting approach, tax gains and losses are netted separately. Afterwards, gains (losses) are allocated to partners who have positive (negative) capital accounts in proportion to their positive (negative) balances. The excess amounts, if any are then allocated on a pro rata basis to all of the partners.

The full netting approach combines all tax gains and losses and allocates only a single net figure to the partners.

4230 Depreciation Recapture

The contribution of §1245 or §1300 recapture property to a partnership in a §721 exchange does not result in depreciation recapture to the contributing partner unless the contributing partner recognizes gain under IRC §731(a)(1) as a result of the contribution. [See IRC §§ 1245(b)(3), 1250(d)(3); Treas. Reg. §§ 1-1245-4(c)(1), 1-1245-4(c)(4) Example 2, 1-1250-3(c)(1), 1-1250-3(c)(2)(vi)]

The potential for depreciation recapture carries over to the partnership.

Example:
K and M form a general partnership, K & M Construction. K contributes $40,000 in cash and M contributes equipment with a fair market value of $40,000 that has

an adjusted basis of $12,000. M originally purchased the property for $50,000 and has taken $38,000 in depreciation deductions at the time of contribution.

If M had sold the equipment to K and M for $40,000, he would have recognized a gain of $28,000 on the property, all of which would be treated as ordinary income from recapture of depreciation. [IRC § 1245] Depreciation recapture is not generally recognized upon contribution of property to a partnership. When a partner contributes depreciated property to a partnership in a nonrecognition transaction, the recapture provisions apply only to the extent that gain is required to be recognized on the transaction (ie. Any gain recognized from the transfer of encumbered property). [IRC § 1245(b)(3)] The partnership's basis in the equipment is $12,000. The partnership steps into M's shoes and continues to claim the depreciation deductions on the equipment using the same schedule M used prior to the contribution. [IRC § 168(i)(7)(A) and (B)] M is only deferring the recapture of depreciation since the potential recapture on the equipment carries over to the partnership. The recapture will be allocated to the partners "in the same proportion as the total gain is allocated," unless a specific special allocation of depreciation recapture is made.

If the partnership later sells the fully depreciated property, the first $50,000 of proceeds will be ordinary income from recapture. The difference between the FMV of the equipment and M's basis at the time of contribution is allocated to M under IRC §704(c).

4300 CONTRIBUTION OF SERVICE FOR PARTNERSHIP INTEREST

4310 Service in Exchange for Profits Interest

A **profits interest** is defined as any partnership interest other than a capital interest. [Revenue Procedure 93-27; 1993-2 C.B. 343]

It has been suggested that a profits interest can be defined as "an interest which will give rise to a partnership capital account (thus justifying a potential distribution to the partner) only if and when there is future economic income in the partnership, in excess of the service partner's draws." [Townsend, "The Controversy Over Campbell: Slicing the Bologna Too Thin," 52 Tax Notes 83, 84 (1991)]

In general, if a person receives a profits interest in a partnership in exchange for services performed in anticipation of being a partner, the event is not a taxable transaction for the partnership or the partner. Revenue Procedure 93-27 does not represent the position of the IRS on the substance of the law; rather its effect is to assure taxpayers that the Service will not attempt to tax transfers of profits interests in most, but not all, typical situations in which partnership interests are transferred for services.

The exceptions to this rule are:

- if the profits interest relates to a substantially certain and predictable stream of income form partnership assets (e.g. income from high quality debt securities or high-quality net leases);
- within two years of receipt, the partner disposes of the profits interest; or
- the profits interest is a limited partnership interest in a publicly traded partnership (within the meaning of IRC §7704(b)).

Prior to Revenue Procedure 93-27, the Courts held that the receipt of a profits interest in a partnership in exchange for the performance of services was a taxable event.

- In the Diamond decision, 56 T.C. 530 (1971), the Tax Court held that the receipt of a profits interest in a partnership in exchange for the performance of services was a taxable event. In this case, the taxpayer was a mortgage broker and arranged financing for a building owned by the partnership. In return, the taxpayer received an interest in partnership [profits and losses. The interest was freely transferable and was sold shortly after receipt for $40,000. The taxpayer treated the gain on the sale as a capital gain. The court held that the receipt of the profits interest was compensation income under IRC §61 and therefore was ordinary income. The court found that since the interest was sold within three weeks after it was received for $40,000, the interest was worth at least that amount when it was received by the taxpayer. The Seventh Circuit affirmed the decision in this case, but urged the Commissioner to promulgate clarifying regulations. The affirming opinion implied that the profits interest received by the taxpayer constituted taxable income upon receipt because its market value was capable of determination at the time of receipt. [492 F.2d 286 (7th Circuit, 1974)]

- In Campbell v. Commissioner, T.C. Memo 1990-162, rev'd 943 F.2d 815 (8th Circuit, 1991), the Tax Court held that a taxpayer who received an interest in the future profits of a partnership in exchange for services recognized immediate taxable income equal to the economic and tax benefit value of the interest. The Court reached this decision by finding that the partnership interest was property for the purposes of applying IRC §83 (treatment of property received in exchange for services).

See ¶ 5.02[6] of McKee, Nelson & Whitmire, *Federal Taxation of Partnerships*, Third Edition for further details.

4320 Valuation of Profit Interest in Exchange for Services

Revenue Procedure 93-27 provides that the receipt of a **profits** interest for services rendered by a partner is taxable in three separate situations. The valuation required in each situation is as follows [Practitioners Publishing Co, Tax Planning Guide, Chapter 3]:

- If the profits interest related to a substantially certain and predictable income stream, the value of the interest will probably be the present value of the income stream.
- If the profits interest received is disposed of within two years of receipt, the value will probably be determined at the time of disposition and equal the value on the date of disposition.
- If the profits interest is an interest in a publicly traded partnership, the value will probably be the market value of similar interests.

Prior to Revenue Procedure 93-27, the Courts have decided quite differently on the value of a profits interest received for services performed.

- The Court in the Diamond case found valuation easy. It used the sales price obtained by the taxpayer three weeks after the partner received the interest.
- Other courts have adopted a liquidation approach [D.B. St. John; Kenroy, Inc. 47 TCM 1749]. The determination of value is made as if the partnership were liquidated on the date that the interest was transferred to the service partner; the value of the service partners' interest is equal to the amount they would receive at liquidation. Generally, the amount received is $0 since the partner does not have any interest in partnership capital and the future allocation of profits to the service provider is impossible to value since such profits are contingent upon uncertainties.
- The most recent approach is that of the Campbell court, which found that the value of the profits interest received was too speculative to result in the recognition of income. [Campbell v. Commissioner, T.C. Memo 1990-162, rev'd 943 F. 2d 815 (8th Circuit, 1991)] There is potential danger to the taxpayer when a court adopts this approach. In cases where a transaction was taxable, but the amount of income was incapable of determination, the courts have applied the "open transaction doctrine." Under this doctrine, the character of all subsequent receipts is determined with reference to the character of the initial transaction. (See Burnet v. Logan, 283 U.S. 404 (1931)) If the approach were applied to a service partner, such as the taxpayer in the Campbell case, all subsequent allocations would be ordinary in character, notwithstanding the provisions of IRC §702.

4330 Contribution of Services in Exchange for a Capital Interest

A **capital interest** is defined as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership." [Revenue Procedure 93-27]

A person who provides services in exchange for an interest in partnership capital recognizes compensation income [Treas. Reg. § 1.721-1(b)(1)]. Under IRC §83, a partner receiving a capital interest in exchange for services is taxed at the time the interest is received unless it is "substantially vested." Property becomes substantially vested "when it is either transferable or not subject to a substantial risk of forfeiture." [Treas. Reg. § 1.83-1(a); Hensel Phelps Construction Co., 74 TC 939, 954 n.6 (1980), aff'd, 703 F2d 485 (10th Cir. 1983)]

If substantial risk of forfeiture exists, the service partner may elect under IRC §83(b) to be taxed at the time of receiving the interest on the "restricted" interest. The interest must be valued without taking into consideration the substantial risk of forfeiture, and the election must be made within 30 days of the receipt of the interest.

Tax consequences also result to the partnership from the transfer of a capital interest to a partner in exchange for services rendered to the partnership. Generally, the value of the interest transferred is a guaranteed payment that is either deductible or capitalized by the partnership, depending on the nature of the services performed. (See IRC §§83(h) and 707) For instance, if the partner contributes services to syndicate the partnership, the partnership must capitalize the value of the interest transferred under IRC §709.

4340 Valuation of Capital Interest

If property is substantially vested at the time it is transferred, it is required to be valued at the time of the transfer. [Treas. Reg. § 1.83-1(a); Hensel Phelps Construction Co., 74 TC 939, 954 n.6 (1980), aff'd, 703 F2d 485 (10th Cir. 1983)] Otherwise, it is generally valued as it becomes substantially vested.

There are several methods used to determine the value of a capital interest in a partnership. The methods which have been allowed by the courts include:

- determining the fair market value by the prices of comparable interests in the partnership sold near the time of the transfer [Larson, Thomas E., (1988) TC Memo 1988-38];
- determining the value the interest received by reference to the value of the services performed [Hensel Phelps Construction Co., (1980) 74 TC 939, affd (1983, CA 10) 51 AFTR 2d 83-1006, 703 F2d 485, 83-1 USTC];
- determining the amount the contributing partner would receive upon liquidation. [Federal Taxation of Partnerships and Partners; McKee, Nelson, Whitmire (1998)]

4400 TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP

4410 Partner Acting in Capacity as a Partner

The legislative history of IRC §707(a)(2)(A) describes in detail the factors that must be considered under the regulations in determining whether an allocation and distribution is made to a partner acting in his capacity as a partner. [S. Report No. 169, 98th Congress, 2nd Sessions 228-230 (1984)]

- The first factor is whether the payment is subject to the risk of the partnership's business. To the extent an allocation and distribution to a partner is reasonably certain, the partner is acting in an individual capacity and should be treated as an independent contractor.
- The next two factors are the duration of the payee's partnership status and the timing of the payment in relation to the provision of services. If a partner status is transitory, an allocation and distribution resemble a fee rather than a return o investment. If an allocation and distribution is close in time to the performance of services or transfer of property, the transactions are likely to be considered related. The reasoning behind this is that the risk of nonpayment increases with time.
- The forth factor centers on the recipient partner's motivation in becoming a partner, i.e., whether based on the facts and circumstances, it appears that tax considerations caused the association. This factor is not weighed significantly in the analysis.
- The fifth factor is whether the allocation in question is disproportionately large in relation to the recipient partner's interest in the partnership's profits. A short-term allocation that is greater than the recipient's profits interest may suggest that the allocation is a disguised fee.

Example:

A partnership is formed to invest in stock. The partnership admits a stockbroker as a partner. The broker agrees to effect trades for the partnership without the normal brokerage commission. In exchange for an interest in the partnership, the broker contributes 51% of partnership capital and receives a 51% interest in residual partnership profits and losses. In addition, the broker receives an allocation of gross income that is computed in a manner that approximates his foregone commission. It is expected that the partnership will have sufficient gross income to make the allocation. The agreement provides that the broker will receive a priority distribution of cash from operations up to the amount of the allocation.

Even though the broker's allocation appears contingent and not fixed as to an amount, it is computed by means of a formula similar to a normal brokerage fee and varies according to the services performed rather than according to the income of the partnership. Therefore, the Senate Report concludes that this contingent gross income allocation should be treated as a fee under IRC §707(a) rather than as a distributive share and partnership distribution. It is assumed that the partnership will have sufficient income to make the allocation.

4420 Disguised Sales- General

A partner's contribution of property to a partnership followed by a partnership distribution may be treated as a sale between the partnership and a non-partner. [Treas. Reg. § 1.707-3(a)(1)(&(2)]

If a partner contributes property to a partnership and within 2 years receives a distribution of money or other property from the partnership; the transaction is deemed to be a sale unless the facts and circumstances clearly establish that the transfers do not constitute a sale. [Treas. Reg. § 1.707-3(c)]

Transfers made more than two years apart are presumed not to be a sale. [Treas. Reg. § 1.707-3(d), (3)(f) Example 5, 7]

- Each of these presumptions may be rebutted only by facts and circumstances (listed below) that clearly establish otherwise. [Treas. Reg. § 1.707-3(c)(1), (3)(d) Example 3, 5, 6, 8]
- Just because a subsequent distribution occurs more than two years later does not automatically mean that the disguised sale treatment is not applicable.

Example:
C transfers undeveloped land to the CD partnership in exchange for a partnership interest. The partnership intends to construct a building on the land.

At the time of the transfer, the land has an adjusted basis of $500,000 and a fair market value of $1,000,000. The partnership agreement provides that the partnership will distribute $900,000 to C upon completing construction of the building. If the transfer of the money is made within two years of the transfer of land, the transfer is presumed to be a partial sale of the transferred land. C may rebut the presumption by showing that the facts and circumstances clearly establish that the $900,000 payment to C would be make without regard to his transfer of the land or that CD's obligation to make the $900,000 payment depended, at the time of the transfer, on the entrepreneurial risks of partnership operation. [Treas. Reg. § 1.707-3(f) Example 3]

Transfers resulting from a **termination of a partnership** by means of either discontinuing the partnership business or sale or exchange of more than 50% interest in the partnership are **disregarded**. [Treas. Reg. § 1.707-3(a)(4)]

IRC §§721 & 731 are still applicable (tax free contribution and distribution) if:

- partnership liabilities are not incurred in anticipation of the contribution; or
- partnership liabilities are not incurred in anticipation of the distribution. [Senate Report No. 169, 98th Congress, 2nd Session 228-230 (1984)]

The fact that a contribution has the effect of shifting liabilities from the transferor partner to the partnership, creating a deemed distribution under IRC §752(b) will not always constitute a disguised sale. [Oehschlager v. Comr., TC Memo 1988-210; Cf. 4431 infra]

The transaction will be considered a sale if based on the facts and circumstances:

- the transfer of money would not have been made except for the transfer of property; and
- in cases in which the transfers are not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

The IRS has listed facts and circumstances, each which indicates that the transaction is a disguised sale because at the time of the earlier transfer, the later transfer wasn't dependent on "entrepreneurial risks" of partnership operations [Treas. Reg. § 1.707(3)(b)(2)]:

- that the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of the transfer;
    - that the transferor has a legally enforceable right to the subsequent transfer;

  - o that the partner's right to receive the transfer of money or other consideration is secured, taking into account the period during which it was secured;
  - o that any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;
  - o that any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;
- that the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to make the transfer, taking into account the likelihood that the partnership will be able to incur the debt;
  - o that the partnership holds money or other liquid assets beyond the reasonable needs of the business, that are expected to be available to make the transfer;
  - o the partnership distributions, allocations, or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;
  - o that the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and
  - o that the partner has no obligation to return or repay the money or consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of the obligation is small in relation to the amount of money or other consideration transferred by the partnership.

Example:
A and B form an equal partnership. A contributes property having a fair market value of $100,000 and an adjusted basis of $50,000. B contributes $50,000 in cash. A and B have capital accounts that reflect $100,000 and $50,000 respectively. During the coarse of the year, the partnership distributes $50,000 to A. Under the rules of IRC § 721 and § 731, the contribution and distribution would be tax-free. But, under the rules of IRC §707(b)(2)(B), if a partner transfers money or other property to a partnership and the partnership makes a related transfer of money or other consideration, the transaction is treated as a sale of property to the partnership. In this case, A must recognize a gain of $50,000 on the sale.

4430 Effects of Liability on Property

- The disguised sale rules may also apply if the contributing partner received a loan related to the property in anticipation of the contribution to the partnership and the partnership or other partners assumes responsibility of repayment of the loan. [Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 232 (1985)]

Note*:* For a detailed discussion of liabilities, see RIA ¶ B – 1650 or PTM 5000.

4440 Qualified Liabilities- Definition

A liability assumed or taken subject to by the partnership in connection with a transfer of property to the partnership by a partner is a qualified liability if:

- the liability was incurred by the partner more than two years before the earlier of the date the partner agreed in writing to transfer the property or the date that the transfer of property to the partnership occurred ("the two year period"). [Treas. Reg. § 1.707-5(a)(6)(i)(A)] The liability must have encumbered the property for the entire two-year period;
- the liability was incurred by the partner within the two-year period, but was not incurred in anticipation of the transfer of property to the partnership. [Treas. Reg. § 1.707-5(a)(6)(i)(B)] there is a presumption that a liability incurred within 2 years of a transfer was incurred in anticipation of the transfer unless the facts and circumstances clearly show otherwise; [Treas. Reg. § 1.707-5(a)(7)(ii)]
- the liability is, under the rules of Treas. Reg. §1-163-8T (relating to the allocation of debt for purposes of the limitations on interest expense deductions), allocable to capital expenditures with respect to the property; [Treas. Reg. § 1.707-5(a)(6)(i)(C)] or
- the liability was incurred in the ordinary course of the trade or business in which the property transferred to the partnership was used or held, but only if all of the assets related to that trade or business are transferred to the partnership other than assets that are not material to the continuation of the trade or business, [Treas. Reg. § 1.707-5(a)(6)(i)(D)] and

To be considered a qualified liability, a recourse liability cannot exceed the fair market value of the transferred property (less the amount of senior priority liabilities that encumber the property or are liabilities described in the last two points above) at the time of the transfer. [Treas. Reg. § 1.707-5(a)(6)(ii)]

Example:

A and B form a partnership. A transfers $500,000 in cash to the partnership and B transfers an office building. At the time of the transfer, the building has a basis of $400,000 and a fair market value of $1,000,000 and was encumbered by a $500,000 non-recourse liability that B incurred 12 months prior to the transfer. The proceeds were used by B to purchase other property. There were no facts that rebut the presumption that the liability was incurred in anticipation of the transfer of the property to the partnership. Accordingly, the liability is not a qualified liability. [Treas. Reg. § 1.707-5(f), Example 1]

4450 Assumption of Qualified Liabilities

If a transfer of property to partnership is not otherwise considered a sale, the assumption of a qualified liability by a partnership does not cause the transfer to be treated as a sale. [Treas. Reg. § 1.707-5(a)(5)(i)]

If the transfer is treated as a sale, the assumption or taking the property subject to a qualified liability is treated as additional consideration in the sale only to the extent of the lesser of:

- the amount of consideration which the partner would be deemed to receive under the rules of assuming a nonqualified liability (see below); [Treas. Reg. § 1.707-5(a)(5)(i)(A)] or
- the amount obtained by multiplying the amount of the qualified liability by the partner's net equity percentage with respect to the property. [Treas. Reg. § 1.707-5(a)(5)(i)(B)]

A partner's net equity percentage is equal to the percentage obtained by dividing:

- the total amount of money or other consideration received by the partner from the partnership (other than amounts with regard to the qualified liability) that are treated as proceeds from the sale of the property, [Treas. Reg. § 1.707-5(a)(5)(ii)(A)]
- by the excess of the fair market value of the property at the time it is transferred to the partnership over
  - any qualified liability which encumbers the property,
  - any qualified liability allocable to the property if allocable to capital expenditures, or

  any qualified liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held, but only if all of the assets related to that trade or business are transferred, other than assets that are not material to the continuation of the trade or business. [Treas. Reg. § 1.707-5(a)(5)(ii)(B)]

Example 1:

F transfers property Z to partnership AF. At the time of the transfer, the property had a fair market value of $165,000, a basis of $75,000 and was encumbered by a $75,000 recourse liability that met the rules for a qualified liability. Assume that F's share of the liability is $25,000.

Since the liability is a qualified liability and no other transfers of money or other consideration were made to F, the assumption of liability by AF is not treated as a sale. [Treas. Reg. § 1.707-5(f), Example 5]

Example 2:
Assume the same facts as the previous example, except that the partnership transfers $30,000 to F in consideration for the transfer in addition to assuming the liability. Since the partnership transferred money to F, the assumption of the $75,000 liability is treated as additional consideration to F to the extent of the ***lesser*** *of (1) the amount that the partnership would be treated as transferring to F if the liability were a nonqualified liability ($75,000-25,000=$50,000) or (2) the amount obtained by multiplying the amount of the qualified liability ($75,000) by F's net equity percentage with respect to the property. F's net equity percentage is equal to the percentage determined by dividing the aggregate amount of money or other consideration from the partnership to the partner ($30,000) by the excess of the fair market value of the property at the time it is transferred to the partnership over any qualified liability encumbering the property ($165,000-75,000=90,000) (30,000/90,000=1/3x75,000=25,000) Thus, the assumption of liability would be treated as a transfer of an additional $25,000 of consideration to F. As a result, F is treated as receiving a total of $55,000 of consideration in the sale. F has a gain of $30,000, since his basis in the sale portion was $25,000 (55,000/165,000x75,000) [Treas. Reg. § 1.707-5(f), Example 6]*

Note: *For more examples, See Treas. Reg. §1.707-5(f).*

4460 Assumption of Nonqualified Liabilities

If a partnership assumes or takes property subject to debt other than qualified liabilities (defined in PTM 4440), the partnership is treated as transferring consideration to the extent the amount of the liability exceeds the partner's share of liability immediately after the partnership assumes or takes the property subject to the liability. [Treas. Reg. § 1.707-5(a)(1)]

Example:
A & B form partnership AB. A transfers $500,000 in cash to AB and B transfers an office building. At the time of the transfer, the building has a basis of $400,000 and a fair market value of $1,000,000 and was encumbered by a

$500,000 non-recourse liability that is not a qualified liability. In accordance with the partnership agreement, B's share of the liability is 50% or $250,000. The partnership's taking the building subject to the liability is treated as a transfer of $250,000 to B ($500,000-250,000 B's share of liability). This results in a $150,000 gain to B ($250,000-100,000(25% x400,000) basis allocated to the sale portion). [Treas. Reg. § 1.707-5(f), Example 1]

4470 Consequences of Disguised Sale Treatment

A transfer of property by a partner to a partnership and a transfer of consideration by a partnership to a partner are treated as a sale or exchange of that property to the partnership by the partner acting in a non-partner capacity (See PTM 4410). [Treas. Reg. § 1.707-3(a)(2)]

The sale is considered to have taken place on the date that the partnership is considered the owner of the property. [Treas. Reg. § 1.707-3(a)(2)]

If the fair market value of the property transferred to the partnership is greater than the consideration transferred to a partner pursuant to a sale, the transfer is treated as a sale in part and a contribution in part.

Example:
A transfers property X to partnership AB on April 9, 1992, in exchange for an interest in the partnership. At the time of the transfer, property X has a fair market value of $4,000,000 and an adjusted tax basis of $1,200,000. Immediately after the transfer, the partnership transfers $3,000,000 in cash to A. Assume that the transfer is treated as a sale of property to the partnership (disguised sale). Because the amount of cash A receives on April 9, 1992, does not equal the fair market value of the property, A is considered as having sold a portion of property X with a value of $3,000,000 to the partnership in exchange for cash. Accordingly, A must recognize $2,100,000 of gain ($3,000,000 amount realized less $900,000 adjusted basis ($1,200,000 multiplied by $3,000,000/4,000,000). Assuming A receives no other consideration for the sale of the property, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,000,000 of the fair market value of the property with an adjusted basis of $300,000 ($1,200,000 less $900,000). [Treas. Reg. § 1.707-3(f), Example 1]

Note: *When a transaction is recharacterized from a contribution to a disguised sale, in addition to the recognition of gain or loss, the partnership's basis in the property as well as the partner's basis in the partnership may be affected.*

4480 Exceptions—Guaranteed Payments and Preferred Returns

In general, the following payments to a partner are not treated as payments under the disguised sale rules: [Treas. Reg. § 1.707-4(a)(1)(i)]

- guaranteed payments. (see PTM 4481)
- preformation expenditure reimbursements. (see PTM 4482)

4481 Guaranteed Payments

Guaranteed payments for capital are defined as any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital. [Treas. Reg. § 1.707-4(a)(1)(i)]

In many cases, a legitimate guaranteed payment could be treated as part of a disguised sale since it is not subject to entrepreneurial risks of partnership operations if tested under Treas. Reg. §1.707-3. Therefore, under these regulations, a legitimate guaranteed payment for capital is excepted from the general rule and is not treated as a disguised sale. [Treas. Reg. § 1.707-4(a)(1)(i)]

- A transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital and that is **reasonable** is presumed to be a guaranteed payment for capital and not part of a disguised sale unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale. [Treas. Reg. § 1.707-4(a)(1)(ii)]
- A guaranteed payment or preferred return is **considered reasonable** only to the extent the transfer is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and only to the extent that the payment is made for the use of capital after the date on which that provision is added to the partnership agreement. [Treas. Reg. § 1.707-4(a)(3)(ii)]
- A transfer of money that is made to a partner during any partnership taxable year and that is characterized as a preferred return or guaranteed payment for capital is reasonable in amount **if** the sum of any preferred return and any guaranteed payment for capital that is payable for that year does not exceed the amount determined by multiplying **either**:
    - o the partner's unreturned capital at the beginning of the year; [Treas. Reg. § 1.707-4(a)(3)(ii)] ,or, at the partner's option,

- o the partner's weighted average capital balance for the year, by the safe harbor interest rate for that year. [Treas. Reg. § 1.707-4(a)(3)(ii)]

4482 Preferred Returns

A **preferred return** is a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain. [Treas. Reg. § 1.707-4(a)(2)]

The disguised sale rules are not intended to prevent a partner from receiving a partnership interest for a contribution of property which interest grants him priorities or preferences regarding distributions, if the arrangement is not in substance a disguised sale. [Senate Report No. 169, 98th Congress (1984) Volume 1 p. I-231]

Example 1:
A transfers property with a fair market value of $100,000 to partnership AB. At the time of the transfer, the partnership agreement is amended to provide that A is to receive a guaranteed payment for the use of A's capital of 10% of the fair market value of the transferred property in each of the three years following the transfer. The partnership agreement provides that partnership net taxable income and loss will be allocated equally between partners A and B and the partnership cash flow will be distributed in accordance with the allocation of partnership net taxable income and loss. The partnership would be allowed a deduction in the year paid if the transfers to A are treated as guaranteed payments under IRC §707(c). The partnership agreement does not provide for payment of a preferred return other than the guaranteed payment to be paid to A. The transfer is characterized as a guaranteed payment for capital and is determined without regard to partnership income. The transfer is also reasonable within the meaning of Treas. Reg. §1.707-4(a)(3). Therefore, the transfer is presumed to be a guaranteed payment. The presumption relating to transfers made within two years of each other does not apply to this transfer. [Treas. Reg. § 1.707-4(4)Example 1]

Example 2:
C and D form partnership CD. C transfers property with an adjusted basis of $20,000 and a fair market value of $100,000 to CD in exchange for a partnership interest. D manages the partnership operations and makes no capital contribution to the partnership. The partnership agreement provides that C is to

receive an annual payment characterized as a guaranteed payment of $8,333 for the use of his capital for the first four years following the transfer.

The partnership agreement also provides that partnership net taxable income and loss will be allocated 75% to C and 25% to D, and that partnership cash flow (determined without regard to the guaranteed payment) will be distributed in the same way, except that guaranteed payments made to C are payable solely out of D's share of partnership cash flow. If D's share of the partnership cash flow is insufficient to make the guaranteed payment to C, then D is obligated to contribute the difference to the partnership, even in the event of a liquidation of the partnership. Thus, the effect of the guaranteed payment arrangement is that the guaranteed payment is funded entirely by D. The partnership complies with the requirements of Treas. Reg. §1.704-1(b)(2)(ii)(b). Suppose at the time the partnership was formed, the partnership or D could borrow $25,000 (equivalent to 25% interest in the partnership's capital assets pursuant to a loan requiring equal payments of principal and interest over a four-year term at the current market interest rate of approximately 12% and that the highest applicable federal rate in effect at the time of the transfer is 10%.

The transfer of money to C under the partnership agreement is characterized by the parties as a guaranteed payment for capital, is determined without regard to partnership income, and is reasonable, the transfer is presumed to be a guaranteed payment, rather than a sale. (However, it should be noted that "a party's characterization of a payment is, in fact, a guaranteed payment for capital will not control in determining whether a payment is in fact a guaranteed payment for capital. " [Treas. Reg. § 1.707-4(a)]) The transfer will not be treated as a sale unless the facts and circumstances establish that the transfer is not a guaranteed payment for capital and is part of a sale..

For the first four years of partnership operations, C receives guaranteed payments of $33,332 in accordance with the partnership agreement. If the characterization of the payments is respected, C would be allocated $24,999(75% of $33,332) of the deductions that would be claimed by the partnership for those payments, which leaves C's capital account approximately $25,000 less than it would be if the guaranteed payments had not been made. The outcome is the guaranteed payments have the effect of offsetting approximately $25,000 of the credit made to C's capital account for the property transferred to the partnership by C. C's capital account is approximately equal to the capital account C would have had if C had contributed 75% of the property to the partnership. The effect of D's funding the guaranteed payment (either through reduced distributions or additional contribution) to C is that D's capital account is approximately equal to the capital account that D would have had if D *contributed 25% of the property (or $25,000 cash). A $25,000 loan requiring equal payments of principal and interest over a four-year term at an annual interest rate of 12% would have resulted in annual payments of $8,230.86 that includes principal and interest. Therefore, the guaranteed payments effectively put the partners in the economic position that they would be in if D had bought a 25% interest in the property from C (financed at the current market interest rate) and then C and D contributed their interests' in the property to the partnership. Accordingly, D has effectively purchased through the partnership a 25% interest in the property from C.*

Under these facts, the presumption that the transfers to C are guaranteed payments for capital is rebutted, because the facts and circumstances clearly establish that the transfers are part of a sale and not guaranteed payments for capital. Under Treas. Reg. § 1.707-3(a), C and the partnership are treated as if C had sold a one-quarter interest in the property to the partnership in exchange for a promissory note evidencing the partnership's obligation to make the guaranteed payment. [Treas. Reg. § 1.707-4(a)(4), Example 2]

4490 Payments Treated as Payments to an Outsider

If a partner provides services or transfers property to a partnership and there is a direct or indirect allocation and distribution to that partner and the performance of the service and the allocation and distribution, when viewed together, are properly characterized as a transaction between the partnership and a partner acting other than in his capacity as a partner (See PTM 4410), the allocation and distribution are treated as a transaction between the partner and an outsider. [IRC § 707(a)(2)(A)]

The purpose of this rule is to prevent partnerships from receiving a deduction for capital expenditures and to prevent partners from converting ordinary income into capital gain. [Senate Report No-169, 98th Congress, (1984) Volume 1 p. I-225]

These provisions do not apply to every situation in which a partner obtains a partnership interest by contributing services or property to the partnership. This section is to apply to allocations that are determined to be related to the contribution of property or services that have economic effect of payment for the property or services. [Senate Report No. 169, 98th Congress, Vol. 1 p. I-226]

Example:
P Associates is a partnership with three equal partners. It has $100,000 of income (determined without regard to syndication costs). It pays Lisa, a partner,

$10,000 for services in connection with the acquisition of land. The payment is for services performed outside of Lisa's capacity as a partner. Therefore, the partnership must capitalize it. Each partner's share of the partnership's income is $33,333. (Lisa has an additional $10,000 of income for the performance of services.)

If P instead allocates and distributes $10,000 of partnership income to Lisa in payment for his services, only $90,000 of partnership income would be allocated to the partners. ($30,000 to each, and Lisa reports an additional $10,000 for services.) The partners have achieved the effect of a $10,000 deduction since they are reporting less than had in the paragraph above. In accordance with IRC §707(a)(2)(A), the tax treatment of the allocation and distribution would be the same as the treatment for the payment for services. P Associates is not allowed a current deduction for the expense, but must capitalize it.

4500 DISTRIBUTIONS OF CONTRIBUTED PROPERTY

4510 General

If a partner contributes property with a basis different from its fair market value at the time of contribution to a partnership (IRC §704(c) property) and within seven years ((CA does conform) of the contribution, the partnership distributes the property to a noncontributing partner, the distributed property is treated as sold by the partnership for its fair market value at the time of the distribution. (For contributions prior to June 9, 1997, gain or loss was recognized on distributions within five years.)

The contributing partner must recognize any gain or loss from this constructive sale in the amount equal to the built in gain or loss in the property. (See PTM 4200)

No gain or loss is recognized if the property is distributed to the contributing partner. [Treas. Reg. § 1.704-4(c)(2)]

The period during which gain is recognized on distributions of contributed property begins on and includes the date of contribution. [Treas. Reg. § 1.704-4(a)(4)(i)]

The rules requiring recognition of gain or loss on distributions of contributed property do not apply to deemed distributions resulting from partnership terminations. [Treas. Reg. § 1.704-4(c)(3)]

See PTM 2500 and PTM 2600 for more discussion regarding distributions of contributed property and the seven year rule.

4520 Exchanges of Contributed Like Kind Property

If a partner contributes property to a partnership, the partnership distributes the contributed property to another partner and within the seven year time period, the partnership distributes, within the time period described in the Regulations, to the contributing partner property that is of "like kind" to the contributed property, then the contributing partner is treated as having contributed to the partnership the like kind property, but only to the extent of the value of that property. [Treas. Reg. § 1.704-4(d)(3)] In the event the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under IRC §704(c)(1)(B) would be reduced by the amount of built in gain or loss in the distributed like kind property in the hands of the contributing partner immediately after the distribution.

Example:
A, B and C form partnership ABC. A contributes to the partnership land with a basis of $250,000 and a fair market value of $1,000,000 at the time of contribution. B contributes to the partnership a building with a basis of $600,000 and a fair market value of $1,000,000 at the time of contribution. The land and building are like kind property. C contributes $1,000,000 in cash to the partnership. Two years after the formation of the partnership, it distributes the land to B and the building to C. The distribution takes place within the time limits. At this time, the land has a fair market value of $1.2 million and the building has a fair market value of $1.4 million.

As a result of the distribution of land to B, A must recognize a gain of $750,000. Because the properties are like kind and because the building has been distributed to C, B is treated as having contributed the building in exchange for a distribution of the land. Therefore, B is not required to recognize any gain or loss as a result of the exchanges.

4530 Distribution of Contributed Property Anti-abuse Rules

If the principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of IRC §704(c)(1)(B), the IRS can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the meaning of this section. [Treas. Reg. § 1.704-4(f)(1)]

- Whether a tax result is inconsistent with those rules must be determined based on all the facts and circumstances.

Example:
On January 1, 1994, R, S and T form RST Partnership as equal partners. R contributes Property 1, nondepreciable real property with a fair market value of $10,000 and an adjusted basis of $1,000. S and T each contribute $10,000 cash.

On December 31,Year 4, the partners agree to distribute the property to S in complete liquidation of S's interest in the partnership. If property 1 were distributed at that time, R would recognize a $9,000 gain that is the difference between the fair market value and the adjusted basis because the property was distributed less than seven years after contribution (five year rule applies for California purposes). On becoming aware of the potential gain recognition, and with a principal purpose of avoiding that gain, the partners amend the partnership agreement on Dec. 31, Year 4 and take other steps necessary to provide that substantially all of the economic risk and benefits of property 1 are borne by S as of Dec. 31, Year 4 and that substantially all of the economic risks and benefits of all other partnership property are borne by R and T. The partnership holds property 1 until January 5, Year 8, at which time it is distributed to S in complete liquidation of S's interest in the partnership.

Although the actual distribution took place more than five years after its initial contribution, the steps taken by the partnership in Year 4 are the equivalent of an actual distribution of Property 1 in complete liquidation of S's interest as of that date. In allowing the contributing partner to avoid recognition of gain on this transaction would undermine the purpose of IRC §704(c)(1)(B) and the regulations. As a result, the steps taken by the partnership on Dec. 31, Year 4 are treated as causing a distribution of Property 1 to S on that date and R recognizes gain of $9,000 at that time. [Treas. Reg. § 1.704-4(f)(1)]

4540 Contribution to an Investment Partnership

If a partner contributes property to a partnership which may be classified as an investment company (See PTM 4550) **and** if "diversification" (See PTM 4560) of the contributor's investment is found to occur, the contributor must recognize gain realized on the transfer.

The gain recognized is equal to the excess of the value of the partnership interest received in the exchange over the adjusted basis of the assets contributed to the partnership. [IRC § 1001] If the value of the partnership interest cannot be determined, the value of the assets transferred to the partnership may be used. [Philadelphia Park Amusement Co. v. U.S., 126 F. Supp. 184 (Ct. Cl 1954); Farid-Es-Sultaneh v. Comr., 160 F.2d 812(2nd Cir. 1974)]

Once a partnership is classified as an investment partnership, the transfer of **any** appreciated property is subject to gain recognition[18]; this includes real estate or other assets.

No loss is recognized on the contribution of property to an investment company. [Senate Report No. 938, 94th Cong., 2d, pt.2 at 43 (1976).]

Example 1:
J owns 100 shares of common stock in a publicly traded corporation. The shares have a basis of $10,000 and a fair market value of $20,000. J transfers the stock to JB Partnership in exchange for a 10% interest in the partnership. JB is an investment partnership by definition. The partnership interest J receives is presumed to be worth $20,000. J recognizes $10,000 capital gain upon the transfer. The partnership's basis in the stock received is $20,000. J's basis in his partnership interest is $20,000. [IRC § 722 states basis includes gain recognized under IRC § 721(a)]

Example 2:
N owns a parcel of land used as a parking lot for his retail business. N contributes this land to a partnership investment company. The partnership intends to sell its securities and use the proceeds to construct a shopping plaza on the land contributed by N. N's basis in the land is $10,000 and the value of the land is $18,000. N must recognize $8,000 §1231 gain (since the property was used in the contributing partner's trade or business) on the contribution of land to the partnership. [Example from Tax Management Portfolio: Partnerships; Overview, Conceptual Aspects and Formation VB2(a)]

Example 3:
J owns 100 shares of common stock in a company listed on the New York Stock Exchange. The stock has a basis of $40,000 and a fair market value of $30,000. J held this stock as an investment. J transfers this stock to ABC Partnership, a partnership investment company, in exchange for a 10% interest in the partnership. J cannot report the loss on the transfer of stock to the partnership. J's basis in his partnership interest is $40,000. The partnership's basis in the stock received is $40,000.

4550 Definition of Investment Company

IRC §721(b) does define an investment company. This section of the Code refers to IRC §351.

The following are the **most crucial** points when considering whether a partnership is an investment company. They include that:

- more than 80% of the partnership's assets must be held for investment purposes [Treas. Reg. § 1.351-1(c)(1)(ii)(a)];

- cash and evidence of indebtedness are now included in 80% computation (for contributions after June 8, 1997) [Treas. Reg. § 1.351-1(c)(1)(ii)(c)];
- the determination of whether the 80% threshold is met is made **after the transfers have been made** to the partnership [Treas. Reg. § 1.351-1(c)(2)];
- the investment assets must be readily marketable. [Treas. Reg. § 1.351-1(c)(3)] Readily marketable is defined as one that is or can be publicly traded. [Treas. Reg. § 1.351-1(c)(3)]

Example 1:
*In 1996, R contributes stock with a fair market value of $20,000 and a basis of $5,000 to a partnership in exchange for a partnership interest. Immediately **before** the transfer, the partnership owns the following assets:*

Asset	*Value*
Cash	*$10,000*
Stocks	*$50,000*
Land	*$25,000*
Total	*$85,000*

*After R's contribution, the partnership owns $70,000 worth of stock and $105,000 worth of assets total. The partnership is **not** considered an investment company before R is admitted because the value of the stock ($50,000) does not exceed 80% of the value of all partnership assets other than cash ($85,000 less 10,000=$75,000). After R's contribution, the partnership becomes an investment company because the value of the stocks ($70,000) exceeds 80% of the value of all partnership assets other than cash ($75,000). Therefore, R is required to recognize gain of $15,000 on the contribution of stock to the partnership.*

Although IRC §721(b) is intended to prevent tax-free diversification of securities portfolios, it requires recognition of gain upon the contribution of property other than securities to a partnership investment company. [Senate Report N. 938, 94th Congress., 2d Session, pt. 2 at 43 (1976)]

In determining whether the partnership assets are held for investment purposes, the same intent principals used in determining whether a taxpayer held property as a capital asset apply. [Treas. Reg. § 1.351-1(c)(3)] The purpose for which it is held by the partnership is controlling. A partnership operating as a securities dealer cannot be treated as an investment company.

The 80% test cannot be avoided by tiered partnerships. (See example below)

- A parent partnership may be classified as an investment company even though its only asset is an interest in another partnership; if the subsidiary partnership owns readily marketable securities, the ownership of the securities is attributable to the parent partnership. [Treas. Reg. § 1.351-1(c)(4)]
- If the parent owns 50% or more of the subsidiary partnership, the parent partnership will be deemed to own a ratable share of the subsidiary's marketable stocks and securities. [Treas. Reg. § 1.351-1(c)(4)]
- The share of the subsidiary's marketable investments allocated to the parent is equal to the portion of the parent's ownership in the subsidiary. The value of the partnership interest is not included in the computation.

Example 2:
The AB Partners is a partnership whose only asset is a 75% interest in CD Partners. CD Partners owns $2 million worth of publicly traded stocks. B, a partner in AB transfers $200,000 worth of publicly traded stocks with a basis of $50,000 to AB Partners in exchange for an interest in the partnership. For purposes of the 80% test, the $1,500,000 value of AB Partner's interest in CD is disregarded. Alternately, AB Partners is treated as owning $1,500,000 (75% x$2,000,000) of marketable securities owned by CD Partners. Immediately after receiving B's contribution, AB is treated as owning $1,700,000 (1,500,000+200,000) of marketable securities. Since these are the only assets held by AB, they exceed the 80% threshold and the partnership is classified as an investment company.

***Observation**: Classification as an investment company can be easily avoided by falling below the 80% threshold. There are several other concerns that may be addressed if no gain or loss is recognized upon the transfer. The partners must remember that all pre-contribution gains and losses are allocated to the contributing partner. [IRC § 704(c)(1)(A)] A subsequent distribution of an asset received by the partnership as a contribution may result in the recognition of gain or loss. [IRC § 704(c)(1)(B) and § 737]*

***Note:** The 80% test is normally applied immediately after the assets are transferred to the partnership. [Treas. Reg. § 1.351-1(c)(2)] The regulations apply an "integrated" plan rule to the term "immediately after". If several investors transfer marketable securities at alternate points in time, the transfer may be viewed as part of an integrated plan, in which the 80% measurement will not be applied until after the last contribution occurs and will include all earlier contributions. [Comm. v Ashland Oil and Refining Co., 99F.2d 588 (6th Circuit. 1938)]*

4560 Diversification Requirement

IRC §721(b) is not applicable unless there was a "diversification" of the transferor's investment portfolio for the transfer to result in the recognition of gain. [Treas. Reg. § 1.351-1(c)(1)(i)]

Diversification occurs if other investors transfer different assets to the same partnership. [Treas. Reg. § 1.351-1(c)(5); Rev. Ruling 87-9] (See Example below)

If two or more investors transfer identical assets to a newly organized partnership, the pooling has not resulted in a diversification. [Treas. Reg. § 1.351-1(c)(5); Rev. Ruling 88-32]

An insignificant element is disregarded under the de minimis rules. [Treas. Reg. § 1.351-1(c)(5)]

The effect of diversification can be negated if:
- each transferor is allocated all of the income and gains (or losses) from the assets the partner contributed, and
- upon withdrawal from the partnership, the withdrawing partner is returned the property originally contributed.

Example 1:
S and D form an equal partnership. S contributes $50,000 worth of stock in X Corporation to the partnership and D contributes $50,000 worth of stock in Y Corporation to the partnership. The newly formed partnership is a partnership investment company and diversification has occurred for both S and D.

Example 2:
R, D and C form a three-person partnership. R and D each contribute $49,500 worth of stock in X Corp for 49.5% interests in the partnership. C contributes $1,000 worth of stock in Y Corp for a 1% interest in the partnership. In determining whether diversification has occurred, C's contribution is disregarded. Therefore, no diversification is has occurred and no gain or loss is recognized. [Treas. Reg. § 1.351-1(c)(7) Example (1)]

4600 PARTNERSHIP'S BASIS OF CONTRIBUTED PROPERTY

4610 Basis of Contributed Property- General

A partnership's basis in property contributed by a partner is equal to the adjusted basis of the contributing partner in the asset contributed at the time of contribution. [IRC § 723]

- If a gain is recognized by the partner on account of a contribution of appreciated property to an **investment partnership**, then the amount of the partner's recognized gain is added to the partnership's basis in the property. [IRC § 723]

Example:
J and T form a partnership. In exchange for a 50% interest in capital and profits, J contributes undeveloped land with a fair market value of $2,000 and an adjusted basis of $500. T contributes $2,000 in cash for the other 50% interest. In accordance with IRC §721(a), neither the partner, nor the partnership recognizes any gain as a result of the contributions. Under IRC §722, J's basis in his partnership interest is $500, which is the adjusted basis of land that J contributed. T's basis in the partnership interest is $2,000, which is equal to the amount of money J contributed. The partnership's basis in the property is $500. If the partnership subsequently sells the property for $2,000, it will realize a gain of $1,500 that will be allocated to J under IRC §704(c).

4620 Basis of Personal Property Contributed

If a partner contributes personal use property to a partnership that will be used by the partnership for business use, the partnership's basis for the property for the purposes of determining gain or loss is the lesser of its value at the time of the contribution or its adjusted basis in the contributing partner's hands-1[9] It is unclear whether the contributing partner's basis in his partnership interest is equal to the same amount.

- This special rule is an application of the general rules governing the conversion of personal assets to business use assets. [Treas. Reg. § 1/165-9(b), § 1-167(g)-1]

- This basis rule prevents an individual who owns a personal use asset with a built in loss from being able to deduct the loss by converting the personal use property to business use.
- The special basis rule applies only for losses and depreciation purposes; therefore, the partnership may have to maintain a second basis for the asset to determine the amount of any gain realized on the sale of the asset.

Example:
B owns a truck that was used exclusively for personal purposes. B originally paid $25,000 for this truck. After using the truck for 2 years, he contributes it to a partnership in exchange for a partnership interest. At the time of the contribution, the truck was worth $15,000. B's adjusted basis in the truck was $25,000 since depreciation is not allowed for personal use assets. For depreciation purposes, the basis of the truck is $15,000.

The partnership uses the truck in its business and takes a $2,600 depreciation deduction for that year. The partnership sells the truck after the first year for $10,000. The partnership's adjusted basis in the truck is $12,400 (15,000 fair market value less 2,600 depreciation). The ***loss*** *on the sale of the truck is limited to $2,400 (10,000 sales price less 12,400 adjusted basis).*

Assume that instead of selling the truck for $10,000, the partnership sells the truck for $16,000 at the end of the first year. Since the adjusted basis of $12,400 is used only if there is a loss, the partnerships adjusted basis for determining the gain is $22,400 ($25,000 original cost less 2,600 depreciation). Therefore, the partnership realizes no gain or loss.

4700 HOLDING PERIODS

4710 Holding Period of Interest: Capital Assets or §1231 Property

If a partnership interest is acquired in exchange for a contribution of property that is a capital asset or depreciable property used in the contributor's trade or business, the holding period of the partnership interest includes the contributor's holding period for the contributed property. [IRC § 1223(1)]

Example:
Partner Q contributes land that was held as a capital asset to Partnership P. Q held the property for 3 years prior to the contribution. Q's holding period after the contribution for his partnership interest is 3 years.

Under IRC §1223(2), a partnership's holding period for a contributed asset includes the holding period of the asset in the hands of the contributing partner.

4720 Holding Period of Interest: Other property

If the partner contributes cash or non-capital, non-§1231 assets in exchange for an interest in a partnership, the holding period of the interest begins on the date the partnership interest is acquired. [Treas. Reg. § 1-1223-1(a)]

Example:
P contributes inventory in exchange for an interest in Q Partnership. P held the inventory for four months prior to contributing it to Q. After the contribution of property to Q, P's holding period of the interest begins on the day the interest is acquired.

4800 CASE LAW

PTM 4810 Disguised Sale

4810 Disguised Sale

Note: The two cases discussed below, *Otey* and *Park Realty* were decided before the enactment of IRC §707(a)(2)(B). The outcome of these cases would likely be different if decided after the enactment of IRC §707(a)(2)(B).

The taxpayer contributed appreciated property to a partnership. The other partner did not contribute any capital. Pursuant to the partnership agreement, the partnership borrowed money and from the loan proceeds distributed cash to the taxpayer in the amount equal to the value of the property contributed. The distribution equalized the partners' capital accounts. The IRS argued that the transaction was in substance, a sale of property to the partnership for cash. The Court rejected the IRS' argument. The court stated the taxpayer had no guarantee that there would be payment, and the transaction was a customary partnership capitalization arrangement.
Otey v. Comr., 70 T.C. 312 (1978), aff'd per curiam, 634 F.2d 1046 (6th Circuit 1980)

The taxpayer contributed appreciated real estate to a partnership in exchange for a capital interest in the partnership equal to the fair market value of the property contributed. After the property was leased, and in accordance with the partnership agreement, the partnership made an extraordinary cash distribution to the taxpayer. The distribution was contingent upon execution of the leases. The intent was to reimburse the taxpayer for the predevelopment costs that it had paid in connection with the property prior to the partnership formation. The IRS argued the transaction was in substance a sale of an interest in the property. The Tax Court did not agree and refused to recharacterize the transaction. The Court emphasized that the taxpayer had made a substantial investment in the property and the contribution to the partnership was motivated by the need for additional capital to develop the property.
Park Realty v. Comr., 77 T.C. 412 (1981), acq., 1982-2 C.B. 2

Two equal partners contributed their stock in two corporations to their partnership and shortly thereafter liquidated the partnership giving one partner all of the stock in one corporation and the other the stock of the second corporation. The remaining partnership assets were divided between them. IRS ruled that the transaction was a taxable exchange of the stock of one corporation for stock in another corporation.

Revenue Ruling 57-200, 1957-1 CB 205

4900 AUDIT ISSUES & TECHNIQUES

4910 General

GATHERING THE FACTS
IS THE MOST IMPORTANT STEP
IN THE AUDIT PROCESS.

4920 Contribution of Services

Issues: The auditor should determine whether the contributing partner received a capital interest or a profits interest in the partnership and verify the value of the interest received for the following reasons:

A partner who contributes services in exchange for a partnership interest may have to report income under IRC §61.

- The distinction is whether the contributing partner receives a capital or profits interest. If the contributing partner receives a capital interest in the partnership, the partner must recognize income when the interest is received. If the contributing partner receives a profits interest in the partnership, the partner may not have to report income in the year received. (See PTM 4310) The partnership agreement should be examined in order to determine whether the interest is capital or profits in nature. Normally, the agreement will state the type of interest or describe the interest received in exchange for the services. A contribution is normally reported on the Partnership's Schedule M-2 although this schedule does not differentiate between a contribution of property or a contribution of services. A cursory check of the partner's individual return should be made to verify the inclusion of the income.

- The valuation of the interest received should also be examined. The auditor should inquire about the method of valuation. If a capital interest was received, the value may be ascertained by determining the fair market value of the partnership interest, using the liquidation method or determining the value of the services performed. (See PTM 4340) If the interest received was a profits interest, the receipt is not taxable unless it meets one of the following tests: 1) the income from the partnership is a steady predictable stream; 2) the profits interest is sold within 2 years; or 3) the partnership interest received is a publicly traded partnership interest. (See PTM 4330)

4930 Contribution of Unencumbered or Encumbered Property

Issue: Was the transaction (contribution) in essence a sale of property to the partnership?

- A partner contributes property to a partnership **in exchange** for an interest in the partnership.

The issue is whether the partner's interest in the partnership increased after the contribution. If the partner's interest in the partnership did not increase, the contribution is not a tax-free contribution [IRC § 721(a)], but rather a sale of property to the partnership. Contributions are reported on the Schedule M-2 and the Schedule K-1s of the partnership return.

- A partner encumbers property or receives a loan in anticipation of contributing the property to the partnership and the loan is assumed by the partnership.

The issue is whether this transaction should be treated as a sale by the contributing partner of the partnership. The effect of this is the contributing partner receives cash prior to the contribution, which may be treated as a sale. The contribution of property is reported on the Schedule M-1 and the loan would be reported on the balance sheet. Since the balance sheet does not break down the liabilities, the auditor should ask the partnership about the liabilities and how they were acquired. Loan documents may be requested to verify who received the proceeds of the loan.

- A partner contributes property to a partnership in exchange for an interest in the partnership and the partnership makes a distribution to the contributing partner.

The issue is whether this transaction was a sale by the contributing partner to the partnership. The regulations provide that the substance of the transaction will govern, rather than the form. [Treas. Reg. § 1.721-1(a)] The contribution will be reported on the partnership's Schedule M-2 and the Schedule K-1s. The distribution will be reported on the partnership's Schedule M-2 and the Schedule K-1s. The contribution and distribution will not necessarily be completed during the same tax year and therefore, the auditor may have to examine partnership returns for several years. The transaction could be classified as a sale of property to the partnership by a partner.

If there was a subsequent sale of the contributed property by the partnership, the issue is whether the built in gain or loss was allocated correctly to the contributing partner.

Techniques:

The auditor should examine the partnership agreement to determine if any property was initially contributed and if so, were any liabilities associated with the property assumed by the partnership. The financial statements may also be useful tools since statements prepared by an accounting firm will normally include footnotes that will explain certain transactions. Also, the auditor should examine the partnership returns for several years to determine if there was a property contribution and if the contributing partner received a distribution. These two items would be reported on the Schedule K-1 and M-2 of the partnership return. Also, the auditor should determine if the property contributed has been subsequently sold by the partnership. The sale should be reported on the partnership return or in the partnership's financial statements. The auditor can also determine whether the property has been sold by checking the property tax roles and sales documents on Lexis.

4940 Distribution of Contributed Property

Issue: Had the property distributed by the partnership been contributed by another partner?

- The partnership distributes previously contributed property to a partner in either a liquidating or non-liquidating distribution.

  The issue is whether the property distributed to any partner in either a liquidating or non-liquidating distribution is property that had been contributed to the partnership by a partner. If so, the contributing partner may have to recognize a gain or loss from this constructive sale. This is only applicable if the fair market value of the property at the time of contribution differs from the adjusted basis of the property at the time of contribution. This rule applies for distributions made within 7 years of the contributionThe distribution may be reported on the Schedule M-2 and the Schedule K-1s. Any contributions made should be reported on the Schedule M-2 and Schedule K-1s.

Techniques:

The auditor should examine the partnership agreement to determine if any property was initially contributed. The financial statements may also be useful since statements prepared by an accounting firm will normally include footnotes that will clarify certain transactions. Also, the auditor should examine the partnership returns for several years to determine if there was property contribution. This item would be reported on the Schedule M-2 of the partnership return. The auditor may also want to verify ownership by using Lexis. The partnership may have transferred ownership but neglected to include it on the Schedule M-2 of the partnership return.

4950 Contribution of Property to an Investment Partnership

Issue: Is the partnership classified as an investment company that requires gain recognition on contributions of property by partners?

A partner contributes property to a partnership that is in the business of holding securities and investments.

The issue is whether the contributing partner must recognize a gain on the transfer of property to the partnership. The partnership must be classified as an investment company (See PTM 4550) and diversification (See PTM 4560) of the contributor's investment must occur in order for the contributing partner to be subject to tax. If the requirements are met, the contributing partner must recognize gain on the transfer.

The auditor must first determine whether the partnership qualifies as an investment company. If so, then the auditor must determine if there was diversification of the transferor's investment portfolio for the transfer to result in the recognition of gain. The contribution will be reported on the Schedule M-2.

Techniques:
The auditor should examine the partnership agreement to determine if any property was initially contributed. Also, the auditor may want to examine the financial statements to determine the types of assets owned by the partnership. After the auditor determines that the partnership meets the requirements stated above, the auditor must determine the amount of gain or loss to be recognized by the contributing partner. The gain recognized is equal to the excess of the value of the partnership interest received in the exchange over the adjusted basis of the assets contributed to the partnership. If the value of the partnership interest cannot be determined, the value of the assets transferred to the partnership may

be used. (See PTM 4540) If the contributing partner recognizes gain on the contribution, the partnership's basis in the asset is its fair market value.

5000 BASIS & LIABILITIES

5010 BASIS

A partner's basis in a partnership interest is commonly referred to as a partner's "outside basis". This is one of the most important concepts in partnership taxation. The determination of outside basis is significant in the determination of the following:

- the tax consequences of distributions from the partnership,
- the gain or loss reportable on a disposition or liquidation or a partnership interest,
- the deductibility of losses passed through from the partnership to the partners,
- the basis of property distributed to a partner.

Generally, the aggregate of the partners' adjusted basis in their partnership interest (outside basis) equals the aggregate of the adjusted bases of partnership assets. There are, however, events that may cause a difference between inside and outside basis. The three exceptions include:

- Sale or exchange of a partnership interest or inheritance of a partnership interest,
- Distribution which requires partner to recognize a gain or loss,
- Decrease in basis of a partnership asset on a current distribution or increase/decrease in basis of a partnership asset on a liquidating distribution.

A partner is only required to compute his basis in his partnership interest if the computation is necessary in the determination of his tax liability. [Treas. Reg. § 1.705-1(a)(1)] Ordinarily, basis computations are necessary in the following circumstances:

- to determine the deductibility of the partner's share of a loss from a partnership;
- upon liquidation or disposition of a partner's interest, in order to determine the amount of gain or loss;
- upon the distribution of cash or property to a partner, in order to ascertain the basis of the property received or the taxability of the cash distribution.

5020 CALIFORNIA CONFORMITY TO BASIS, LIABILITIES AND AT RISK

In general, California Revenue and Taxation Code § 17851 conforms to Subchapter K. California also conforms to IRC § 465 with California Revenue and Taxation Code § 17551. If there are areas of non-conformity, they will be discussed in each particular section of this manual.

5030 INITIAL BASIS

A partner's initial basis for his partnership interest is determined pursuant to IRC § 722 if the interest acquired is a result of a contribution to the partnership, or pursuant to IRC §742 if the interest is acquired other than by contribution.
IRC § 722 provides that the initial basis of an interest acquired by contribution is the sum of:

- the amount of money and,
- contributor's adjusted basis in any property contributed. (See PTM 5100)

IRC § 742 provides that if a partnership interest is acquired by means other than contribution, generally the partners basis is equal to cost basis. (See PTM 5140)

5040 ADJUSTMENTS TO BASIS-INCREASES

A PARTNER'S INITIAL BASIS FOR HIS PARTNERSHIP INTEREST IS INCREASED BY HIS DISTRIBUTIVE SHARE OF THE FOLLOWING:

- partnership taxable income as determined under IRC § 703(a) [IRC § 705(a)(1)(A), Unless otherwise specified, all references to the 1954 Internal Revenue Code],
- tax-exempt income of the partnership [IRC § 705(a)(1)(B)],
- excess of partnership deduction for depletion over the basis of the property subject to depletion [IRC § 705(a)(1)(C)],
- capital contributions made by a partner at any time during the year [Treas. Reg. § 1.705-1(a)(2)] (the partners basis will be increased by the money contributed or the adjusted basis of the property contributed), and
- partner's share of the partnership liabilities [IRC § 752(a)] (See PTM 5400)

When an increase to basis adjustment is made, the starting point is zero even though previous decreases would otherwise have produced a negative basis. [Falkoff, Milton, (1974) 62 TC 200]

Example:
A owned an interest in LP Partnership. A's adjusted basis in LP was $100 on January 1, 1996. During 1996, the partnership operated at a loss and A's share of the loss was $50 and there was a $150 distribution of cash. Since the cash distribution was in excess of her basis, A reported a $100 capital gain ($100-50=50 basis after operating loss; $50 of the distribution decreases basis to 0 and the remaining $100 is a capital gain). In 1997, A contributed cash of $20. After the contribution, A's basis is $20.

- Discharge of partnership liabilities results in partnership taxable income which increases the adjusted basis of a partner's interest in the partnership. [IRC § 705(a)(1)(A)] A basis increase applies even if the partner excludes the cancellation of debt income in accordance with IRC § 108(a)(1).

- A partner's adjusted basis in a partnership interest **should not** be increased by his distributive share of partnership tax deferred income. Income that is tax deferred should not result in a basis increase since such an adjustment allows the income to escape taxation rather than merely deferring it to some point in the future.

5050 ADJUSTMENTS TO BASIS-DECREASES

Generally, a partner's basis for his partnership interest is decreased (not below zero) by his distributive share of the following:

- the amount of any cash distributed to him as provided in IRC § 733 [IRC § 705(a)(2)]);
- the basis to him of any property distributed to him by the partnership as provided in IRC § 733 [IRC § 705(a)(2)]);
- his distributive share of partnership losses [IRC § 705(a)(2)(A)];
- expenditures of the partnership not deductible in computing taxable income of the partnership and not properly chargeable to the capital account [IRC § 705(a)(2)(B)];
- the amount of his depletion deductions for oil and gas property as provided under IRC § 613A(c)(7)(d) [IRC § 705(a)(3)] and
- reduction of partner's share of liabilities. [IRC § 752(b)]

The adjustments to basis are made before calculating the loss limitation.
[Revenue Ruling 66-94, 1966-1 CB 166]

5060 ORDERING AND TIMING OF ADJUSTMENTS

The order in which the various basis adjustments are made can be important in applying the loss limitation rules and the current distribution rules. In general, basis is computed at the end of the partnership tax year. However, if a partner transfers, withdraws or liquidates his interest in the partnership, his basis is adjusted as of the date of transfer, withdrawal, even though his distributive share of income or loss has not yet been determined.

- Income or loss is taken into account at the end of the partnership year ordinarily.
- Contributions increase a partner's basis at the time of contribution.
- Distributions ordinarily decrease basis at the time the distribution is made. Basis immediately before a partnership distribution is the relevant basis for determining gain or loss on the distribution.
- Advances or draws of money or property against a partners distributive share of income are treated as current distributions made on the last day of the partnership tax year. [Treas. Reg. § 1.731-1(a)(1)(ii)]
- Deemed distributions resulting from the decrease in a partner's share of partnership liabilities is treated as if it is made on the last day of the partnership tax year. [Revenue Ruling 94-4. 1994-1 CB 195]

Example:
On January 1, 1996, A's basis in his partnership interest is $100 which includes his share of partnership liabilities in the amount of $50. In 1996, the partnership operates at a loss and A's share is $100. This loss decreases A's basis to $0. In 1997, the partnership pays its liability in full. A's share of the partnership liability is reduced to zero and this reduction is treated as a distribution from the partnership on the last day of the partnership's tax year. In this case, A would have a gain in the amount of $50. If the partnership generates income from operations during 1997 and A's share is more than $50, he may not have to recognize a capital gain from the distribution.

5100 CONTRIBUTIONS OF PROPERTY

5110 Contributions in General

The basis of an interest in a partnership acquired by a contribution of property to the partnership is:

- the contributing partner's adjusted basis of such property at the time of contribution
- increased by any gain recognized under IRC § 721 [IRC § 722]

Example:
On January 1, 1996, C and L form an equal partnership. C contributes $40,000 in cash and L contributes unencumbered property with a fair market value of $40,000 and an adjusted basis of $20,000. C's initial basis in her partnership interest is $40,000 (the amount of cash contributed) and L's initial basis in his partnership interest is $20,000 (his adjusted basis in the contributed property)

5120 Contribution of Encumbered Property

If a partner contributes encumbered property to a partnership, the partnership is treated as having assumed the liabilities, to the extent that the liabilities do not exceed the fair market value of the property at the time of contribution. [Treas. Reg. § 1.752-1(e)]

A contribution of encumbered property results in the following two separate basis adjustments:

- Under § 752(b), the partnership's assumption of the contributing partner's liabilities is treated as a deemed cash distribution from the partnership to the contributing partner. The contributing partner's basis in his partnership interest is **decreased** by the amount of the deemed distribution (not below zero). [IRC § 733]

- Since an increase in a partner's share of liabilities is treated as a deemed cash contribution to the partnership by the partner, the contributing partner's share of the liabilities assumed by the partnership will **increase** his basis in the partnership. [IRC § 722]

The contributing partner may be required to recognize taxable gain on the contribution if the deemed cash distribution exceeds the contributing partner's basis in his partnership interest. [IRC § 731(a)(1); § 741]

Gain recognized upon a contribution of encumbered property does not result in an increase in the contributing partner's basis in the partnership, since the gain results only from a deemed cash distribution to the partner in excess of his basis in the partnership. [Revenue Ruling 84-15, 1984-1 CB 158]

Observation:
A typical contribution of encumbered property results in a decrease in the contributing partner's initial basis equal to the liability allocated to all other partners.

5130 Contribution of Services

5131 Contribution of Services in Exchange for Capital Interest

- **Capital Interest** is defined as an interest which entitles the partner to a share of the proceeds of all of the assets were sold at fair market value and the partnership liquidated [Revenue Procedure 93-27; 1993-2 C.B. 343]

- When a partner acquires a capital interest in a partnership in exchange for services, there is no provision in the Code for non-recognition. The regulations provide that a partner who receives an interest in partnership capital as compensation for services must recognize income.[Treas. Reg. § 1.721-1(b)(1)]

- The amount includable in taxable income is the fair market value of the capital interest in the partnership. [Treas. Reg. § 1.721-1(b)(1)]

- The service partner's basis in his partnership interest will be the amount includable in partner's income. [Cost basis under § 1012]

5132 Contribution of Services in Exchange for Profits Interest

A **profits interest** is defined as anything other than a capital interest. [Revenue Procedure 93-27; 1993-2 C.B. 343]

Generally, the receipt of a profits interest in a partnership in exchange for services will not be considered a taxable event for the partner or the partnership. [Revenue Procedure 93-27; 1993-2 C.B. 343]

If services are provided in exchange for a ***future profit interest*** only, it is not quite clear if the service partner has to recognize income immediately on receipt of the interest. [William Campbell, 59 TCM 236, TC Memo 1990-162, rev'd 91-2 USTC 50, 420] The receipt of a future profit interest in exchange for services is not a taxable event **unless**:

- **THE PROFIT OF THE PARTNERSHIP IS SUBSTANTIALLY CERTAIN AND PREDICTABLE,**
- the partner disposes of the profit interest within 2 years of receipt, or
- the profits interest is a limited partnership interest in a publicly traded partnership under IRC § 7704. [Revenue Procedure 93-27, 1993-2 C.B. 343]

5140 Other Acquisitions of Partnership Interests

Generally, the basis of a partnership interest acquired by purchase is its cost.

If a partner pays cash for his interest, his initial basis in his interest is the amount of cash paid.

PTM 5141 Acquisition of Partnership Interest from a Decedent
PTM 5142 Acquisition of Partnership Interest by Gift
PTM 5143 Other Acquisition Issues

5141 Acquisition of Partnership Interest from a Decedent

The initial basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of death.

In a community property state (like California), an interest in a partnership is considered owned by both husband and wife. [Revenue Ruling 79-124, 1979-1 CB 224] For Federal purposes, if a spouse, who is the partner in the partnership, dies, the surviving spouse's basis in the entire inherited partnership interest will be the fair market value of the interest at the date of death as provided by IRC § 1014(a). The result is a stepped up basis in the entire partnership interest. The result may be different for California purposes depending on the date of death. The surviving spouse may not have a stepped up (or stepped down) basis regarding his or her own one-half interest in the partnership.

The successor's basis is increased by its allocable share of liabilities and decreased by items constituting income in respect of a decedent. [Treas. Reg. § 1.742-11; IRC § 1014(a)]

5142 Acquisition of Partnership Interest by Gift

Generally, a partnership interest acquired by gift is the donor's adjusted basis in the interest prior to the transfer.

For purposes of determining loss realized at the disposition of the interest, the donee's basis is limited to the fair market value of the interest at the time of the gift. [IRC § 1015(a)]

5143 Other Acquisition Issues

A lender who took a partnership interest in exchange for canceling the unpaid balance of the indebtedness, had a basis in the partnership equal to fair market value of the partnership interest. The value of the basis is based on the facts that the transaction was at arm's-length and that the partnership had been enjoying profits at the time, was held to be equal to the amount of the unpaid debt. [Sargent, Estill, (1970) TC Memo 1970-214] However, where the lender could not establish a fair market value for the partnership interest because of the financial condition of the partnership, his basis was held to be zero. [Shaheen, George, (1982) TC Memo 1982-445]

5200 DISTRIBUTIONS

5210 Distributions of Cash

- As a general rule, neither the partnership nor the partner recognizes gain or loss on a distribution of money or property in a current or liquidating distribution. (See PTM 6100 and PTM 6200 series)

- Cash distributions reduce a partner's basis by the amount of the distribution (**not below zero**). Non-taxable cash distributions are limited to a partner's basis in his partnership interest. If the distribution exceeds a partner's interest, a capital gain or loss must be recognized.

Example:
On January 1, 1996, C's adjusted basis in his partnership interest is $25,000. During the course of the year, the partnership makes a cash distribution to C in the amount of $40,000. Since the distribution exceeds C's basis, the difference between his adjusted basis and the distribution is a capital gain. In this case, the capital gain is equal to $15,000 ($25,000 adjusted basis less $40,000 cash distribution) and his adjusted basis in his partnership interest is $0. If the distribution had been only $20,000, C would recognized no gain and his adjusted basis in his partnership interest would be decreased to $5,000 ($25,000 adjusted basis less $20,000 cash distribution)

5220 Distributions of Property: Non-Liquidating

- In a non-liquidating distribution, the partner's adjusted basis is decreased by the amount of money distributed and by the partner's adjusted basis in property distributed to him. [IRC § 733]

- Generally, a partner's basis in property distributed by a partnership is equal to the partnership's adjusted basis in the property immediately preceding the distribution. [IRC § 732(a)(1); Treas. Reg. § 1.732-1(a)]

- A partner's basis in distributed property is limited to the partner's adjusted basis in his partnership interest immediately preceding the distribution (decreased by any money distributed in the same transaction). [IRC § 732(a)(2); Treas. Reg. § 1.732-1(a)]

Example:
On January 1, 1996, partner A has a $20,000 adjusted basis in his partnership interest. During the year, the partnership distributes in a non-liquidating distribution, $10,000 cash and property with a fair market value of $15,000 and an adjusted basis to the partnership of $12,000. A's basis in his partnership interest is first reduced to $10,000 ($20,000 adjusted basis less $10,000 distribution). A's adjusted basis in the distributed property is limited to $10,000 that is his adjusted basis in his partnership interest. The $10,000 distribution of property further reduces his adjusted basis in his partnership interest to $0 ($10,000 adjusted basis after cash distribution less $10,000 property distribution).

5230 Distributions of Property: Liquidating

- Generally, no gain or loss is recognized by either the partnership or the partner on a liquidating property distribution.

- A partner's adjusted basis in his partnership interest is decreased to $0 when property is distributed.

- If a partnership distributes property to a partner in liquidation of a partner's entire interest in the partnership, the partner's basis in the distributed property (other than money) is equal to the partner's adjusted basis in his partnership interest immediately preceding the distribution . [IRC § 732(b); Treas. Reg. § 1.732-1(b)]

- Since a liquidating distribution is a distribution in complete liquidation of a partner's interest; there is no need to determine the distributed partner's adjusted basis in his partnership interest after the distribution.

Example:
On January 1, 1996, Partner B has a $20,000 adjusted basis in her partnership interest. During 1996, the partnership distributes to B in liquidation of her entire partnership interest, $5,000 cash and a building with a fair market value of $75,000 and an adjusted basis of $40,000. B's distribution of cash first reduces her basis to $15,000 ($20,000 adjusted basis less $5,000 cash distribution). B's basis in the building is $15,000 which is the adjusted basis of her partnership interest after the cash distribution. There is no gain or loss reported on this transaction.

5240 Alternative Computation of Basis

- Under certain circumstances, the adjusted basis of a partner's interest in a partnership may be determined by reference to his proportionate share of the adjusted basis partnership property. [IRC § 705(b)]

- The alternate rule may be used for determining a partner's basis if the partner cannot practicably apply the general rules of IRC § 705. [Treas. Reg. § 1.705-1(b)]

- When the indirect method of basis calculation is used, the partnership assets should first be reduced by total partnership liabilities and each partner's basis must be determined under the indirect determination rule. Liabilities must then be reallocated among the partners using the liability allocation rules. [Treas. Reg. § 1.705-1(b) Example 3]

- If the alternative rule is used, a partner's adjusted basis may need to be adjusted to reflect discrepancies between a partner's share of the adjusted basis of partnership property and the partnership's adjusted basis in its property. [Treas. Reg. § 1.705-1(b)] These discrepancies may result from property contributions or distributions, or transfers of partnership interests.

Example:
A, B and C are equal partners in a partnership. On January 1, 1995, the partnerships assets consist of a building with an adjusted basis of $50,000 and $10,000 in cash. The total basis of partnership property is $60,000. Each partner's share of the adjusted basis of the partnership's property is $20,000 (60,000 x 1/3). If the alternative rule is used, each partner's basis in his partnership interest is $20,000.

5300 BASIS VS. CAPITAL ACCOUNT

5310 General

- Capital accounts are intended to keep track of partners' contributions, distributions and allocations. The capital account is separate and distinct from his adjusted basis in his partnership interest. [Treas. Reg. § 1.705-1(a)(1)]

- Capital accounts are kept using "book" accounting where basis is kept using "tax" accounting.

- A partner's capital account does not reflect the partner's share of partnership liabilities.

- Upon occurrence of certain events (contributions, distributions and sales of partnership interests), partnership property is accounted for at fair market value for book purposes (in the partner's capital account) regardless of whether fair market value differs from basis.

- Capital accounts can be negative whereas tax basis can **never** fall below zero.

Example:
B contributes unencumbered property to a partnership. His partnership interest is increased by his adjusted basis (under IRC § 722) in the contributed property, but his capital account is increased by the fair market value of the contributed property.

5320 At Risk Limitations-General

The at risk rules are designed to prevent the deduction of "artificial losses" when the taxpayer is protected from suffering an actual out of pocket loss.

The amount at risk for an activity includes:

- the amount of money and the adjusted basis of other property contributed to the partnership with respect to the activity.

- amounts borrowed with respect to the activity. [IRC § 465(b)(1)] This includes borrowed amounts which the partner is personally liable [IRC § 465 (b)(2)(A)] or must have pledged his own property (other than that used by the partnership) as security for the repayment of the borrowed amounts. [IRC § 465 (b)(2)(B)]

- “Qualified non-recourse financing”. Generally qualified non-recourse financing is included as an “amount at risk” if it meets all of the tests below. (see PTM 5330)

If a partner cannot deduct partnership losses because of the at risk limitations, the losses can be carried forward indefinitely. The losses become deductible when the partner has a sufficient amount at risk to deduct the losses.

In general, a taxpayer is not at risk for the amount of any non-recourse loan.[20]

A taxpayer is not considered at risk with respect to amounts borrowed in connection with certain activities if funds are borrowed from a person who has an interest in such activity other than a creditor interest.

The at risk rules apply to any interest acquired after 1986 in a partnership, an S corporation, or any other pass through entity holding real property, regardless of when the entity placed the real property in service. [1986 TRA Section 503(c)(2)]

5330 Qualified Non Recourse Financing

- The funds are borrowed with respect to the activity of holding **real property**.

- The funds are borrowed from a “**qualified person**”. This includes any person actively engaged and regularly engaged in the business of lending money who is **not:** related to the taxpayer, a person from whom the property was acquired or a person who receives a fee with respect to the investment in the property.

- No person is personally liable for repayment of the funds. The debt can be bifurcated and considered part qualified and part nonqualified non-recourse financing.

- No person can be personally liable for repayment of "**qualified non-recourse financing**."

- For a partnership, **qualified non-recourse financing** is to be allocated among the partners in accordance with the rules for determining the partners' respective share of liabilities of the partnership. [IRC § 465(b)(6)(C)] The § 752 regulations provide the necessary rules.

- The fact that the loan is secured by real property **does not** automatically mean that it is used with respect to the activity of holding real property:

Example:
Individual A owns and actively manages an equipment rental business. In order to have a place to store and service equipment, she purchases a commercial garage. She uses funds obtained by a non-recourse loan from a state government agency, secured by the garage. The loan is with respect to the activity of equipment rental, rather than with respect to the activity of holding real property, and the loan therefore cannot be "qualified non-recourse financing." (If the equipment rental business and the garage can be treated as separate "activities" the result would be different)

5400 PARTNERSHIP LIABILITIES

One of the most distinctive features of partnership taxation is the treatment of partnership liabilities. In general, when a partner's share of partnership liabilities increases or when he personally assumes partnership liabilities, he is treated as making a constructive cash contribution to the partnership. Conversely, when a partner's share of partnership liabilities decreases or when his personal liabilities are assumed by the partnership, he is treated as receiving a constructive cash distribution from the partnership. Therefore, the determination of a partner's "share" of partnership liabilities, or a relief thereof, is of vital importance in determining his adjusted basis in the partnership interest. This section discusses:

- Types of Partnership Liabilities,
- Allocation Rules,
- Sharing of recourse liabilities, and
- Sharing of non-recourse liabilities.

5410 General Rules

- Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption of partnership liabilities by such partner, is treated as a cash contribution by the partner to the partnership. [IRC § 752(a)]

- Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of an assumption of the individual liabilities by the partnership, is treated as a cash distribution by the partnership to the partner.[IRC § 752(b)]

5420 When to Determine Partner's Share of Liabilities

A partner's share of partnership liabilities is required to be determined whenever it is necessary to determine the tax liability of the partner or any other person. [Treas. Reg. § 1.752-4(d)]

A partner's share of partnership liabilities may change constantly due to numerous transactions occurring at the partnership level.

The following transactions may cause a shifting in the sharing of partnership liabilities:

- An entry of a new partner into the partnership,
- Retirement of an existing partner,
- A shift in the allocation of profits or losses, (See PTM 1000)
- Repayment of partnership liabilities,
- Recharacterization of a partnership debt from recourse to non-recourse or vice versa,
- A partner's status changes from general to limited or vice versa,
- Changes in a partner's obligation to contribute to the partnership, (See PTM 5530)
- Contributions or distributions of encumbered property, (see PTM 5120 and PTM 5220, PTM 5230), and

- A partner becomes "affiliated" with a lender.

***Observation*:**
For audit purposes, all partnership transactions should be analyzed for potential changes in the partners' share of partnership liabilities and their impact on the partners' adjusted bases in the partnership interests. Many partnership transactions that have nothing to do with partnership liabilities may cause a shift in the sharing of partnership liabilities.

5430 Types of Partnership Liabilities Affecting Basis

5431 What Constitutes Partnership Liabilities

The 1991 Regulations (See PTM 5482) do not contain a definition of what constitutes a partnership liability for IRC § 752 purposes. However, the 1988 Temporary Regulations provide that an obligation is treated as a liability only to the extent that incurring or holding the obligation give rise to:

- the creation of, or an increase in, the basis of any property owned by the obligor;
- a deduction that is taken into account in computing the partnership taxable income; or
- an expenditure that is not deductible in computing the partnership taxable income and is not properly chargeable to capital. [Temp. Reg. § 1.752-1T(g)]

***Observation*:**
*Though the 1991 (Final) Regulations have not included these specific provisions, many tax commentators believe the 1988 Temporary definition of "liabilities" makes sense and expect the application of these provisions to continue. [*See, e.g.,, W. McKee, W. Nelson, R. White, *Federal Taxation of Partnerships And Partners, ¶ 7-1 (2nd Ed. 1990)]*

The purpose of IRC § 752 is to maintain a basis relationship between the partnership's aggregate basis in its assets and the partners' total bases in their partnership interests. Therefore, when a partnership purchases a property and incurs an obligation to the seller as part of the purchasing price, the obligation is part of the partnership's basis in the property and treated as a partnership liability that increases the partners' bases in their partnership interests.

In the same manner, if the partnership borrows money to finance its operations (e.g., paying deductible expenses) or to purchase other assets, the loans are also treated as partnership liabilities.

Example:
A and B are equal partners in partnership AB. A and B each contributes $500 cash to the partnership. The partnership purchases a real property from an unrelated party, paying $1,000 cash and signing a promissory note for $9,000. The partnership's basis in the property is $10,000 which includes $1,000 cash payment and $9,000 obligation. The obligation is also treated as a partnership liability which increases A's and B's bases in their partnership interests by $9,000. Thus, A's and B's aggregate bases in their partnership interests equal the partnership's basis in the property, which is $10,000.

There are certain obligations that give rise to an expenditure but are neither deductible in computing the partnership income nor chargeable to the partners' capital accounts (e.g., premium payment for a general partner's life insurance). These obligations are treated as partnership liabilities since they reduce the partners' bases in their partnership interests.

5432 Cash Basis Partnerships

- If the partnership uses cash accounting method, the accrual basis liabilities (i.e.: accrued, unpaid expenses and accounts payable) are not considered partnership liabilities because they are not deductible by the cash basis partnership until they are paid. [Revenue Ruling 88-77, 1988-2 CB 129]

5433 Completed-Contract Method

Progress payments received by a partnership using the completed-contract method of reporting construction income do not create partnership liabilities since the partnership has fully earned the payments and is under no obligation to return them or perform additional services to retain them. These payments are characterized as "unrealized receivables" and will increase a partner's basis in the partnership when they are recognized by the partnership for tax purposes. [Revenue Ruling 73-301, 1973-2 CB 215]

5434 Contingent Liabilities

- A payment obligation (See PTM 5531) is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs. [Treas. Reg. § 1.752-2(b)(4)]

- Contingent liabilities and claims are not treated as partnership liabilities for the purposes of IRC § 752 because they do not create basis. [Albany Car Wheel Co., Inc., 333 F.2D 653]

- Contingent or contested liabilities will become partnership liabilities when they become fixed or liquidated. [Marshall Long, 71 TC 1 (1978)] "It is settled by many decisions that a taxpayer may not accrue an expense the amount of which is unsettled or the liability of which is contingent…" [Security Flour Mills Co. v. Comr.,321 US 281, 284 (1944)]

- To determine whether or not a liability is contingent, both cash basis and accrual basis partnerships have to use the "all events" test. [Joseph W. LaRue, 90 TC 465, (1988)] This test requires that (1) all events must have occurred to fix the fact of the liability and (2) the amount of the liability must be determinable with reasonable accuracy. [Treas. Reg. § 1.446-1(c)(1)(ii)(A)]

5435 Option Payments

Payments received under an option agreement are not liabilities since there is no unconditional obligation to return the payment. [George Helmer, 34 TCM 727 (1975)]

Example:
A and B are equal partners in partnership AB which owns a piece of land with an adjusted basis of $40,000 and a market value of $1,000,000. A's and B's bases in their partnership interests are $20,000, respectively. During the year, the partnership signs an option agreement with C that grants C an option to buy the land anytime within the next two years at the current market value. C agrees to pay the partnership $100,000 as consideration for the option to purchase the

land. The agreement provides that if C exercises the option within the next two years, the payment will be applied to reduce the purchase price. However, if C does not exercise the option, the payment will not be refunded. Immediately after receiving the payment, the partnership distributes the entire cash proceeds to its two partners. What are the tax consequences of the transactions?

First, the payment of $100,000 is not considered a partnership liability because the partnership is not required to return the payment. Therefore, A's and B's bases in their partnership interests are not increased by the payment. Second, the distribution of the payment to the partners exceeds their adjusted bases in the partnership by $60,000, which represents the gain they have to recognize.

5436 Short Sales

A short sale occurs when an investor sells a security and delivers the security in the future. The short sale is "closed" when the seller meets his obligation to deliver the security.

***Example**:*
On April 1, 1997, Richie sold short 100 shares of TA&A stock for $100 per share. He did not own these shares at the time of the sale but expected that TA&A stock would decline in value by the time he closed the sale. On April 4, 1997, TA&A stock declined to $85 per share. Richie purchased 100 shares and delivered them to his broker to close the short sale. Richie recognized a gain of $1,500.

When a partnership makes a short sale, its obligation to deliver the borrowed securities to the broker to close out the short sale is treated as a partnership liability because it increases the partnership's basis in the short sale (which is a partnership asset). [Revenue Ruling 95-26, 1995-1 C.B. 131]

5437 Sham Transactions

Case law has shown that in some situations, a partnership may incur a large amount of non-recourse debt secured by a property whose value, determined at the time the liability is incurred, is materially less than the debt amount. The debt may be treated as a sham obligation since repayment of the debt may be deemed to be contingent (or even optional) on the future appreciation of the asset.[Est. of Charles T. Franklin, 64 TC 752 (1975), aff'd, 544 F2d 1045 (9^{th} Cir. 1976)] The debt may not be treated as a genuine obligation and therefore not a partnership liability for the purposes of § 752. [Commissioner v. Turf, 43-1 USTC 9328]. However, if the value of the collateral fluctuates or materially decreases after the liability is incurred, the liability may still be respected until some other event occurs that justifies a reassessment of the obligation.

5440 Loans by Partners or Related Persons

In general, a partner who engages in a transaction with a partnership, other than in his capacity as a partner, shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include loans of money or property by the partner to the partnership. [Treas. Reg. § 1.707-1(a)] Thus, loans by partners to the partnership are treated as liabilities of the partnership for the purposes of § 752.

Recourse loans from partners to partnerships are treated as partnership liabilities and allocated to the partners based on their share of the "economic risk of loss" as provided under § 752. (See PTM 5510)

Non-recourse loans from a partner or a related person (See PTM 5540) are also recognized as partnership liabilities but are allocated entirely to the lending partner or the partner related to the lender. (See PTM 5491)

5450 Partner Loans Characterized as Capital Contributions

Loans from a partner to a partnership may be recharacterized as capital contributions if the facts and circumstances show that the substance of the transaction is actually a capital contribution. [Treas. Reg. § 1.707-1(a)] This recharacterization is commonly referred to as the "Thin Partnership" doctrine that parallels the "Thin Incorporation" doctrine of corporate tax law.

The Thin Partnership doctrine was first applied in *Joseph W. Hambuechen*, 43 TC 90 (1964). In this case, the taxpayer made substantial advances to a financially faltering partnership under an agreement providing that the advances were to be placed in a special account on the partnership books, not bearing interest, unsecured and subordinated. The taxpayer claimed a business bad debt deduction when the special account was liquidated. The Service denied the deduction on the theory that no debt existed. The Tax Court agreed with the Service that the loan was actually a capital contribution because:

- Under the same circumstances, no creditor would have made a similar unsecured, subordinate loan to the partnership,
- The advances were unsecured, subordinated to other claims of past, present, and future creditors, and did not bear interest or have a fixed maturity date, and

- There was no reasonable expectation of repayment regardless of the success of the partnership.

It should be noted that taxpayers may attempt to use the Tthin Partnership doctrine to their advantage by arguing that advances made to partnerships and treated as loans should be recast as capital contributions. In *Curtis W. Kingbay*, 46 TC 147 (1966), the Tax Court rejected the taxpayer's argument based on the facts that regular repayments of the debt were made by the partnership, notes were given, the debt was not subordinated, and the partnership's capitalization was normal with regard to its business. In *Donna Woolley,* 61 TCM 131 (1991), the taxpayer attempted to recharacterize a loan as a capital contribution to increase his basis in the partnership interest. The Tax Court distinguished *Hambuechen,* on the grounds that in the case before it, the taxpayer's advances were evidenced by the interest bearing notes, and the taxpayer may have had recourse to the assets of the partnership or other partners. Therefore, the advances were properly characterized as debt, not equity. The taxpayer structured the transactions as loans and should not obtain a more favorable result by resorting to the substance over form theory.

***Observation**:*
The significance of the Thin Partnership doctrine has been reduced by the enactment of the at risk limitations under § 465, the passive loss rules under § 469, and the new Regulations under § 752. (See PTM 5491)

5460 Assumption of Liabilities

- A partner's assumption of partnership liabilities or a partnership's assumption of a partner's personal liabilities is treated as a cash contribution to or cash distribution from the partnership. (See PTM 5410)

- In general, a person is considered to assume a liability only to the extent that he is personally obligated to pay the liability. If a partner or a related person assumes a partnership liability, the creditor must know of the assumption and can directly enforce the partner or the related person to satisfy the liability. In addition, no other partners or a related person of the other partners bears the economic risk of loss with respect to the liability immediately after the assumption. [Treas. Reg. § 1.752-1(d)]

- **Exception**: With regard to the contribution or distribution of encumbered property, the transferee is treated as having assumed the liability, to the extent that the amount of liability does not exceed the fair market value of the property at the time of the contribution or distribution. [Treas. Reg. § 1.752-

1(e)] (**There is no requirement that the creditor must know of the assumption of the liability**.)

***Example**:*
A contributes property with an adjusted basis of $5,000 to a general partnership in exchange for an interest in the partnership. At the time of contribution, the property is subject to recourse debt of $1,000 and has a fair market value in excess of $1,000. The partnership does not have any other outstanding liabilities. After the contribution, A remains personally liable to the creditor and none of the other partners bears any of the economic risk of loss for the liability under state law or otherwise. Under the rule stated above, the partnership is treated as having assumed the $1,000 liability. Therefore, A's individual liability decreases by $1,000. At the same time, however, the entire $1,000 partnership liability is allocated to A because he bears the economic risk of loss. Accordingly, A's initial basis in the partnership interest is $5,000. See Treas. Reg. § 1.752 (g) Example.

***Observation**:*
In the above example, the encumbered liability is "automatically" assumed by the partnership when the property is contributed to the partnership, regardless of whether or not the creditor is aware of the transfer. After the liability becomes the partnership liability, it is allocated entirely to A because A is still personally liable to the creditor and therefore bears the economic risk of loss.

5470 Netting Increases and Decreases in Liabilities

- If, as a result of a single transaction, a partner incurs both an increase and a decrease in the partner's share of partnership liabilities, only the net increase or the net decrease is treated as a contribution or distribution, respectively, of money to or from the partnership.
- Usually, the netting happens when there is a contribution or distribution of property subject to a liability or the termination of a partnership under § 708(b).

***Example**:*
In the above example, A contributed a property subject to $1,000 in liability to a partnership in exchange for a partnership interest. Because the partnership is treated as assuming the encumbered liability, A's personal liability is reduced by $1,000. However, as a partner in the partnership, A is allocated the entire $1,000 liability because he bears the economic risk of loss. The decrease and increase in liability are netted because they are from a single transaction.

5480 Determining Partner's Share of Partnership Liabilities

The Internal Revenue Code provides the tax consequences of the partners' share of partnership liabilities; however, the rules for determining the partners' share of partnership liabilities are left to the Treasury Regulations. There are three sets of Regulations: the 1956 Regulations, the 1988 Regulations, and the 1991 Regulations.

5481 The 1956 Regulations

This set of Regulations, promulgated in 1956 and commonly referred to as the Old Regulations, provides that *recourse* liabilities are to be shared by the general partners (see PTM 3000) in accordance with their loss sharing ratios. *Non-recourse* liabilities are shared among both general and limited partners in accordance with their profit sharing ratios. Furthermore, a limited partner's share of partnership recourse liabilities cannot exceed the difference between his actual contribution to the partnership and the total contribution he is obligated to make under the limited partnership agreement.

The above sharing rules are based on the principle that since general partners are responsible for payment of recourse liabilities if the liabilities are not satisfied by the partnership, they are allocated partnership recourse liabilities proportionately to their loss sharing ratio. With regard to non-recourse liabilities, for which no partner has any personal liability, the only way to repay these non-recourse liabilities is through partnership profits or assets. Therefore, the non-recourse liabilities are shared by all general and limited partners based on their profit sharing ratios.

While the above sharing principles are theoretically sound, the Old Regulations are too general, ambiguous, and caused confusion not only among taxpayers, but for the government as well.

5482 The 1988 and the 1991 Regulations

On December 29, 1988, the IRS issued a new set of temporary and proposed regulations, commonly referred to as the 1988 Temporary Regulations. These regulations are regarded as lengthy and overly complicated. On December 28, 1991, the IRS issued a new simplified set of regulations which is referred to as the 1991 Final Regulations. Together, the Temporary and the Final Regulations are referred to as the New Regulations.

The **principal difference** between the Old and the New Regulations is the concept of "economic risk of loss"(See PTM 5510), which is used as a basis to distinguish between recourse and non-recourse liabilities and to determine the partners' share of recourse liabilities.

5483 Effective Dates and Transition Rules

Before attempting to allocate partnership liabilities, the applicable provisions must be determined. The three sets of Regulations - Old, Temporary, and Final - are effective based on the date that *the applicable liabilities are incurred or assumed by the partnership*, not the date the partnership is formed. A liability is treated as incurred or assumed on the date a written, binding contract becomes effective. [Treas. Reg. § 1.752-5(a)]

5484 The Grandfather Rule

In general, the Old Regulations apply to liabilities incurred before January 30, 1989. The Temporary Regulations apply to liabilities incurred on or after January 30, 1989 but before December 28, 1991. The Final Regulations apply to liabilities incurred on or after December 28, 1991.[Treas. Reg. § 1.752-5(a)]

5485 Election to apply 1991 Regulations

A partnership may elect to apply the 1991 Final Regulations to all of its liabilities, including those liabilities to which these provisions would not otherwise apply, by attaching a written statement to the partnership tax return filed for the first taxable year of the partnership ending on or after December 28, 1991. The written statement must include the name, address, and taxpayer identification number of the partnership making the statement and contain a declaration that an election is being made under Regs. §1.752-5(b). [Treas. Reg. § 1.752-5(b)(2)]

- **If no election** is made by the partnership, the determination of the applicable set of rules is on a liability-by-liability basis, as discussed above.

5486 Technical Termination

A partnership may terminate if within a 12-month period, there is a sale or exchanges of 50 percent or more of the total interest in the partnership capital or profit. This is commonly referred to as a Technical Termination under § 708(b)(1)(B). When a partnership terminates under § 708(b)(1)(B), the liabilities that were incurred or assumed prior to the termination are **not** treated as incurred or assumed on the date of the termination. [Treas. Reg. § 1.752-5(c)] In other words, a technical termination does not cause all partnership liabilities to be treated as incurred or assumed on the termination date.

5487 Material Modification

If a liability that is not subject to the 1991 Regulations is "materially modified," the liability becomes subject to the regulations in effect when the modification occurs. A partner's or a related person's guarantee of a grandfathered liability is not considered a material modification. [T.D. 8380, 1992-1 C.B. 205]

5488 Duty of Consistency

In general, if a partner has filed a tax return and claimed a share of liability in excess of that allocable to him, then to the extent that claiming an excessive share of that liability reduced the partner's taxable income for such year, the partner must determine taxable income for the subsequent tax years in a manner that reflects the excessive share of liability in the earlier return, unless the partner files an amended return to correct the excessive claim. This consistency rule, however, does not preclude the government from determining that the taxpayer did not comply with the regulations. [Treas. Reg. § 1.752-4T(c), replaced by TD 8380, 12/20/91]

5490 Recourse versus Non-recourse Liabilities

One of the most important steps in determining a partner's share of partnership liabilities is to determine if a liability is recourse or non-recourse.

<u>Definition of Recourse Liabilities</u>

Under the Final Regulations, a partnership liability is a **recourse** liability to the extent that any partner or related person (See PTM 5540) bears the economic risk of loss set forth under § 1.752-2. [Treas. Reg. § 1.752-1(a)(1)] (See PTM 5510)

Definition of Non-recourse Liabilities

Under the Final Regulations, a partnership liability is a **non-recourse** liability to the extent that no partner or related person bears the economic risk of loss for that liability set forth under § 1.752-2. [Treas. Reg. § 1.752-1(a)(2)]

Observation:
For a true non-recourse liability, only the lender bears the economic risk of loss if the partnership defaults on the loan. Real estate loans, for instance, are one of the most common types of non-recourse loans. Typically, the real property is pledged as security for the debt and in the event of default, the lender's only recourse is to foreclose on the property.

5491 Non-recourse Loans by Partners

- If a partner or related person makes a non-recourse loan to the partnership, the non-recourse loan will be characterized as recourse loan. [Treas. Reg. § 1.752-2(c)(1)] The reason is because the lender-partner is deemed to bear the economic risk of loss if the partnership defaults on the loan.

- See exceptions to this rule under De Minimis rule (See PTM 5492), Wrapped Indebtedness (See PTM 5495), and Bifurcated Debt (See PTM 5494).

Observation:
Non-recourse loans made by a partner or his related person to the partnership is referred to as "Partner Non-recourse Debt" under Regs. § 1.704-2(b)(4). (See PTM 1000 *Capital Accounts- Allocation of Partnership Income and Loss) For allocation purposes, a debt treated as a partner non-recourse debt has to be allocated to the lender partner since he bears the economic risk of loss. Thus, other partners may not include any portion of this loan in their basis.*

***Example**:*
A and B are equal partners in partnership AB. A and B each contributes $500 cash to the partnership in 1993. The partnership purchases a rental property for $100,000 from C, an S corporation to which B is 100 percent shareholder. The partnership paid C $1,000 in cash and signs a promissory note for $99,000. The note is secured by the property. Neither A nor B are personally liable for the note. Though the note is non-recourse, it is treated as recourse because it is made by a related person to B. B is considered to bear the entire economic risk of loss with regard to the note. As a result, the note is allocated 100 percent to B

to give him a basis of $99,500 in the partnership interest. A's basis in his partnership interest is $500.

5492 De Minimis Exceptions

Under the general rule, the partner's non-recourse debts (See PTM 5491) are treated as recourse and allocated to the lender partner. However, there are two exceptions to this general rule:

- Partner as lender (See PTM 5493)
- Partner as guarantor (see PTM 5494)

5493 Partner as Lender

The general rule **does not** apply if the partner as a lender meets both of the following requirements:

- the lender partner or his related person whose interest in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, and
- the loan made to the partnership constitutes a "qualified non-recourse financing" within the meaning of § 465(b)(6) (determined without regard to the type of activity financed) [Treas. Reg. § 1.752-2(d)] (See PTM 5330)

For the purposes of computing the 10 percent interest in the partnership, both direct and indirect ownership of partnership through one or more partnerships, including the interest of any related person, are taken into consideration. [Id]

5494 Partner as Guarantor

The general rule **does not** apply if the partner as a guarantor meets both of the following requirements:

- The partner meets the 10 percent ownership stated in PTM 5493, and
- Guarantees a loan that would otherwise constitute a qualified non-recourse financing within the meaning of § 465(b)(6) if the guarantor had made the loan to the partnership.

***Observation**:*
*To be a qualified non-recourse loan under § 465 (*See PTM 5330)*, the loan has to be from a qualified lending institution or if from a related person, it has to be commercially reasonable. Thus, the de minimis exception covers essentially*

loans from banks or other lending institutions. This makes sense since the bottom line of the de minimis exceptions is to allow all partners to continue sharing in the qualified non-recourse liabilities rather than reallocating the liabilities to the lender partner provided (1) the lender partner is in the business of lending money and (2) the lender partner's relationship to the partnership is primarily that of a lender as evidenced by the fact that the lender partner holds only a small equity interest (10 percent or less) in the partnership.

5495 Wrapped Debt

If a partnership liability is owed to a partner or related person and that liability includes (i.e., is "wrapped" around) a non-recourse liability encumbering partnership property that is owed to another person, the partnership liability will be treated as two separate liabilities.

The portion corresponding to the wrapped debt is treated as a liability owed to another person. [Treas. Reg. § 1.752-2(c)(2)]

***Example**:*
*Tom holds 25 percent interest in Tommy partnership. The partnership purchases a property from Tom for $100,000, paying $10,000 in cash and signs a promissory note for the balance of $90,000. The note is secured by the property and none of the other partners are personally liable for the note. At the time of the purchase, the property has an encumbered liability of $70,000. The liability is a non-recourse debt owed to the Bank of Sacramento and incurred when Tom purchased the property. The debt is secured by a mortgage on the property. Tom continues to make payments on the $70,000 mortgage to the bank after the property is sold to the partnership. For the purposes of § 752, the partnership note of $90,000 is treated as a wrapped debt that includes the $70,000 owed to the Bank of Sacramento. The liability is a recourse liability to the extent of $20,000 because Tom is the creditor with respect to the note and Tom bears the economic risk of loss for $20,000. The remaining $70,000 is treated as a partnership non-recourse liability that is owed to the Bank. [Treas. Reg. § 1.752-2(f), Ex. (6)]**

Note: Assuming in the above example, the property becomes worthless and the partnership defaults on the $90,000 loan, which causes Tom to default on the $70,000 loan to the bank. Since none of the partners are personally liable for the $90,000 loan, nor is Tom personally liable for the $70,000 loan, the bank bears the economic risk of loss for $70,000 and Tom's net economic risk of loss is only $20,000. Therefore, the above treatment appears reasonable from the economic standpoint.

5500 SHARING OF RECOURSE LIABILITIES

Under the New Regulations, a partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person **bears the economic risk of loss**. (See PTM 5510) [Treas. Reg. § 1.752-2(a)]

Thus, the **economic risk of loss** concept is used not only to distinguish recourse from a non-recourse liabilities but also to determine the partners' share of such recourse liabilities.

Observation:
Under the 1956 Regulations, the sharing of recourse liabilities is based on the partners' ratios for sharing losses. Though this allocation method is theoretically sound, the Regulations promulgated thereunder are criticized as too ambiguous and not useful in resolving even the simple liability-sharing questions, particularly in the context of modern complex partnerships. [See McKee, Ibid., ¶ 8.2]
Under the New Regulations (1988 and 1991), the sharing of recourse liabilities is based on the "economic risk of loss" concept that is derived from the same principle of loss sharing. However, the new regulations attempt to take into account various potential economic or financial arrangements between the partnership and its creditors as well as among the partners. This is part of the reason the new regulations are lengthy and complicated.

5510 Determining A Partner's Economic Risk of Loss

Under the New Regulations, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person will be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or a person related to another partner. [Treas. Reg. § 1.752-2(b)]

Thus, the economic risk of loss test consists of two steps: a **hypothetical constructive liquidation** of the partnership (See PTM 5520) and the **determination of each partner's obligations** (See PTM 5530) to make payments or to contribute to the partnership as a result of the constructive liquidation.

5520 Constructive Liquidation

The first step in the determination of a partner's economic risk of loss is a hypothetical liquidation of the partnership in which all of the following events are deemed to occur simultaneously:

- All of the partnership's liabilities become payable in full;
- All of the partnership's assets, including cash, have a value of zero, except the property contributed to the partnership to secure a partnership liability under § 1.752-2(h)(2));
- All of the partnership's property is disposed of in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership);
- All items of income, gain, loss, or deductions are allocated among the partners;
- The partnership liquidates. [Treas. Reg. § 1.752-2(b)]

The net effect of the constructive liquidation is to create a hypothetical situation in which all of the partnership's assets are deemed worthless or lost. As a result, the constructive losses are allocated among the partners, which cause their capital accounts to be negative. Each partner's negative capital account will be a measure of the net amount (obligation) he has to pay to satisfy partnership creditors or the partners with positive capital accounts. This net amount represents each partner's "economic risk of loss" regarding partnership liabilities. The share of partnership recourse liabilities among the partners is based on this economic risk of loss.

Constructive Liquidation-Computation of Gain or Loss

For purposes of the constructive liquidation, gain or loss on the deemed disposition of the partnership's assets is computed in accordance with the following:

- If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of a partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the tax basis (or book value to the extent § 704(c) or § 1.704-1(b)(4)(i) applies) in those assets. [Treas. Reg. § 1.752-2(b)(2)(i)]

- A loss is recognized equal to the remaining tax basis (or book value to the extent § 704(c) or § 1.704-1(b)(4)(i) applies) of all the partnership's assets not taken into account in paragraph 5037.2(b). [Treas. Reg. § 1.752-2(b)(2)(ii)]

Example 1:
Tom and Jerry form a general partnership with each contributing $100 in cash. The partnership purchases a building from an unrelated party for $1,000, paying $200 in cash and signs a note to the seller for the balance of $800. The note is a general obligation of the partnership, i.e., both Tom and Jerry are personally liable for repayment on the note. The partnership agreement provides that all items are allocated equally, except tax losses, which are specially allocated 90% to Tom and 10% to Jerry, and that the partners' capital accounts are maintained in accordance with § 704(b) regulations, including the obligation to restore the deficit capital account on liquidation. Tom and Jerry's share of the $800 recourse liability is determined as follows:

In a constructive liquidation, the $800 liability becomes due and payable immediately. All of the partnership's assets (which is the building) are deemed to be worthless. The building is deemed to be sold for a zero value, which causes a loss of $1,000 (partnership's cost basis in the building is $1,000.) The loss is allocated to Tom and Jerry. Their capital accounts are adjusted to reflect the hypothetical disposition, as follows:

	Tom	*Jerry*
Initial Contribution	*$100*	*$100*
Loss on Disposition	*(900)*	*(100)*
Ending Capital account	*($800)*	*$0*

There are no other contractual obligations between the partners except the obligation to satisfy the creditor of the partnership ($800). The $800 liability, therefore, is classified as a recourse liability and is allocated entirely to Tom since he would have an obligation to make a contribution in that amount to the partnership to satisfy the recourse loan. See Treas. Reg. § 1.752-2(f), Ex. (1).

Example 2:
Assume the same facts as the above example except that the partnership agreement provides that all items of income or loss are allocated 60% to Tom and 40% to Jerry. Under the same constructive liquidation test, the partnership has $1,000 loss on the hypothetical disposition of the building. The partners' capital accounts are adjusted to reflect the loss, as follows:

	Tom	*Jerry*
Initial Contribution	*$100*	*$100*
Loss on Disposition	*(600)*	*(400)*
Ending Capital account	*($500)*	*($300)*

Tom and Jerry's capital accounts reflect the deficits of $500 and $300, respectively, that they have to restore. Therefore, the $900 note is a recourse liability because one or more partners bear the economic risk of loss for the liability. Also, Tom's and Jerry's shares of the recourse liability are $500 and $300, respectively. See Treas. Reg. § 1.752-2(f), Ex. (2).

Note: In the above two examples, the computation of the loss on the deemed disposition is based on the partnership's tax basis in the building. The creditor's right to repayment is not limited solely to the building of the partnership because the note is a general obligation of the partnership (partners are personally liable for repayment, as stated in the Examples.)

5530 Obligations to Make Payment or Contribution

As discussed in PTM 5510, under the New Regulations, a partner bears the economic risk of loss with respect to a partnership liability to the extent that, upon the partnership's constructive liquidation, the partner is obligated to make a payment to any person, or a contribution to the partnership.

The determination of the extent to which a partner or a related person has an obligation to make a payment is based on the facts and circumstances at the time of the determination. All statutory and contractual obligations relating to the partnership liability are taken into account for the purposes of the determination, including: See Treas. Reg. § 1.752-2(b)(3).

- Contractual obligations outside the partnership agreement such as guarantees, indemnification, reimbursement agreement, and other obligations running directly to creditors, to other partners, or to the partnership.

- Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of a partnership.

- Payment obligations (whether directly to another partner or to the partnership) imposed by state law including the governing state partnership statute.

Any obligations that are not described above are **not** recognized as valid obligations for the purpose of § 752. [Treas. Reg. § 1.752-2(b)(3)]

5531 Contingent Obligations

If a payment obligation is subject to contingencies that, based on all facts and circumstances, make it unlikely that the obligation will ever be discharged, the obligation is disregarded.

If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs. [Treas. Reg. § 1.752-2(b)(4)]

Example:
Paul and Paula form a general partnership with cash contributions of $5,000 each. The partnership purchases a rental property paying $10,000 in cash and signs a note for $90,000. The note is non-recourse, secured by the rental property. The loan document provides that the partnership will be liable for the outstanding balance of the loan on a recourse basis to the extent of any decrease in value of the rental property resulting from the partnership's failure to maintain the property. There are no facts that establish with certainty the existence of any liability on the part of the partnership or its partners for damages caused by the partnership's failure to properly maintain the rental property. Therefore, no partner bears the economic risk of loss, and the liability constitutes a non-recourse liability. [Treas. Reg. § 1.752-2(f), ex. (8)]

5532 Reimbursement Rights

If a partner or related person is entitled to reimbursement from another partner (or a related person of the other partner), their payment obligation is reduced by the amount of reimbursement. [Treas. Reg. § 1.752-2(b)(5)]

5533 Deemed Satisfaction of Obligation

For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. [Treas. Reg. § 1.752-2(b)(6)] (See PTM 5630)

5540 Related Person

Under the 1991 Regulations, a person is related to a partner if the person and the partner bear a relationship to each other that is specified in § 267(b) or § 707(b)(1), modified as follows:

- All references to "more than 50 percent" are replaced by "80 percent or more";
- Brothers and sisters are not included in a person's family; and
- Disregard §§ 267(e)(1) and 267(f)(1)(A). [Treas. Reg. § 1.752-4(b)(1)]

Related Person Under Modified § 267(b)
Based on the provisions under § 752, the modified version of § 267(b) regarding a related person is as follows:

- Members of a family (including a spouse, ancestors, and lineal descendants; brothers and sisters are not included);
- An individual and a corporation if the individual owns, directly or indirectly, more than 80 percent of the value of the outstanding stock of the corporation;
- Two corporations which are member of the same controlled group as defined under § 1563(a) without regard to §267(f)(1)(A).
- A grantor and a fiduciary of any trust;
- A fiduciary of a trust and a fiduciary of another trust, if both trusts have the same grantor;
- A fiduciary of a trust and a beneficiary of such trust;
- A fiduciary of a trust and a beneficiary of another trust if both trusts have the same grantor

- A fiduciary of a trust and a corporation if the trust or its grantor owns more than 80 percent of the value of the outstanding stock of the corporation;
- A person and an organization to which § 501 applies if the organization is controlled directly or indirectly by such person or, if the person is an individual, by members of the individual's family;
- A corporation and a partnership if the same person owns more than 80 percent in the value of the outstanding stock of the corporation, and more than 80 percent of the capital interest, or the profits interest, in the partnership;
- An S corporation and another S corporation if the same person owns more than 80 percent the outstanding stock of each corporation;
- An S corporation and a C corporation, if the same person owns more than 80 percent the outstanding stock of each corporation.

5541 Person Related to More Than One Partner

In applying the rules discussed in PTM 5540, if a person is related to more than one partner, he should be treated as related only to the partner with whom there is the highest percentage of ownership. If two or more partners have the same percentage of related ownership, the liability is allocated equally among the partners having equal percentage of related ownership. [Treas. Reg. § 1.752-4(b)(2)(i)]

For purposes of determining the percentage of related ownership between a person and a partner, natural persons who are related by virtue of being members of the same family are treated as having a percentage relationship of 100 percent with respect to each other. [Treas. Reg. § 1.752-4(b)(2)(ii)]

Related partner exception: persons owning interests directly or indirectly in the same partnership are not treated as related persons for purposes of determining the economic risk of loss born by each of them. However, this exception does not apply when determining a partner's interest under the de minimis rule. (See PTM 5492)

Example:
F and S are father and son who each owns 8 percent interest in a partnership. For purposes of determining the economic risk of loss, each of them has to compute their own economic risk of loss to determine their share of partnership

recourse liabilities without taking into account their father-son relationship. However, as stated above, this exception does not apply in determining if a lender owns 10 percent or less interest in a partnership under the de minimis rule. Therefore, if the father makes a non-recourse loan to the partnership, both his own interest in the partnership and his son' interest in the partnership are taken into account, which in this case, exceeds the 10 percent threshold. Therefore, the non-recourse loan is treated as a recourse loan and allocated to the lender partner.

5542 Entities Structured to Avoid Related Person Status

If:

- A partnership liability is owed to or guaranteed by another entity (which can be a partnership, an S corporation, a C corporation, or a trust),
- A partner or related person owned (directly or indirectly) 20% or more ownership interest in the other entity; and
- A principal purpose of having the other entity act as a lender or guarantor of the liability was to avoid the determination that the partner who owns the interest bears the economic risk of loss for federal income tax purposes,

then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner or related person's ownership interest in the entity. [Treas. Reg. § 1.752-4(b)(2)(iv)]

***Example**:*
Al, Burt, and Carol are equal partners in general partnership ABC. Each contributes $10,000 to the partnership. The partnership wants to buy a property for $100,000. Al and Burt want to loan money to ABC and have the loan treated as non-recourse for purposes of § 752. Al and Burt form a new partnership AB and each contributes $35,000. Al and Burt are equal partners in partnership AB. Partnership AB loans partnership ABC $70,000 on a non-recourse basis, secured by the property partnership ABC is going to purchase with the loan. Under these facts and circumstances, Al and Burt bears the economic risk of loss with respect to the partnership ABC's $70,000 loan equally, based on their equal loss-sharing ratios in partnership AB. Carol's basis in partnership ABC does not include any portion of the $70,000 loan. [Treas. Reg. § 1.752-4)b)(2)(iv)(C)]

5550 Partner Guarantees Interest on Loan

A lender may require one or more partners to guarantee the interest payments on a non-recourse loan made to the partnership. In such situation, the loan is treated as partially recourse and partially non-recourse as provided below:

General Rule

If one or more partners or related person have guaranteed the payment of more than 25 percent of the total interest that will accrue on a partnership non-recourse liability over its remaining term, and it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed future interest if the partnership fails to do so, then the partnership liability is treated as two separate partnership liabilities. The partner or related person that provides the guarantee is treated as bearing the economic risk of loss for the liability to the extent of the present value of future interest payments. The remainder of the stated principal amount of the partnership liability constitutes a non-recourse liability. [Treas. Reg. § 1.752-2(e)(1)]

In applying this rule, it is reasonable to expect that

- the guarantor will be required to pay substantially all of the future interest if the partnership defaults on payment, and
- the lender can enforce the interest guaranty without foreclosing on the property and thereby extinguishing the underlying debt.

This rule, once applicable, will remain in effect even after the point at which the amount of guaranteed interest is reduced to less than 25 percent of the total interest that will accrue on the property. [Treas. Reg. § 1.752-2(e)(1)]

Example 1:
Ron is a partner in RL partnership. On January 1, 1995, the partnership obtains a $2,000,000 non-recourse loan secured by an office building owned by the partnership. According to the loan agreement, neither the partnership nor any partner has any personal liability for repayment of the principal amount. The loan has an annual interest rate of 15%, payable on the last day of each year. The principal is payable in a lump sum on December 31, 2009. Ron guarantees payment of 50 percent of each interest payment required by the loan. The guarantee can be enforced without first foreclosing on the property. When the partnership obtains the loan, the present value (discounted at 15%, compounded annually) of the future interest payments is $1,754,211 and of the future principal payment is $245,789. Since a partner guarantees 50 percent of the future payments, which is $877,106 ($1,754,211 x .5), this amount is treated as a recourse liability because Ron, the guaranteeing partner, bears the economic risk

of loss. The remainder of the principal, $1,122,894, ($2,000,000 - 877,106) is treated as a partnership non-recourse liability. [Treas. Reg. § 1.752-2(f), Ex. (7)]

It should be noted that in applying this provision, the original principal amount of the partnership loan ($2,000,000) is bifurcated into two separate portions. The portion that relates to the present value of the guaranteed interest payments ($877,106) is treated as recourse and allocated to the guaranteeing partner. The remainder of the loan ($1,122,894) is treated as non-recourse and allocated to all partners in accordance with the non-recourse rules.

***Example 2**:*
Same as the above example, except that two years after providing the guarantee that he would pay 50 percent of total future interest payments in case of default by the partnership, Ron negotiates with the lender and is allowed to reduce the guaranteed amount to 20 percent of the total future interest. Does this change affect the original bifurcation of the liability? The answer is no. Once the interest guarantee rule applies, which results in the bifurcation of the partnership liability into recourse and non-recourse, the bifurcation will remain in effect until all the guaranteed interest is paid even if the guaranteed interest amount is changed to less than 25 percent of the total interest that will accrue on the liability.

Computation of Present Value

The present value of the guaranteed future interest payments is computed using the discount rate equal to:

- The interest rate stated in the loan document, or
- The applicable federal rate if the interest rate is imputed under either § 483 or § 1274, compounded semiannually. [Treas. Reg. § 1.752-2(e)(2)]

If the loan document contains variable rates based on current values of an objective interest index, the present value is computed on the assumption that the interest determined under the objective interest index on the date of the computation will remain constant over the term of the loan. [Treas. Reg. § 1.752-2(e)(2)]

The term “objective interest index” has the meaning given under § 1275 and the regulations thereunder. Examples of an objective interest index include the prime rate of designated financial institution, LIBOR (London Interbank Offered Rate), and the applicable federal rate under § 1274(d). [Treas. Reg. § 1.752-2(e)(2)]

Safe Harbor

The interest guarantee rule does not apply to a partnership non-recourse loan if the guarantee of interest by the partner or related person is for a period not in excess of the lesser of five years or one-third of the term of the liability. [Treas. Reg. § 1.752-2(e)(3)]

De Minimis Exception

The interest guarantee rule does not apply if:

- The partner or related person who provides the guarantee owns 10 percent (or less) interest in each item of partnership income, gain, loss, deduction, or credit for every taxable year the partner is a partner in the partnership; and
- The loan constitutes a qualified non-recourse loan under § 465(b)(6) (regardless of the type of activity financed). [Treas. Reg. § 1.752-2(e)(4)]

Note: For purposes of the above 10 percent rule, the allocation of the guaranteed interest which is paid by the guaranteeing partner does not count.

5600 PARTNER PLEDGING PROPERTY AS SECURITY FOR PARTNERSHIP LOAN

It is not unusual for a lender to require one or more partners of the borrowing partnership to pledge their own property as security for a loan. In such situation, the determination of the economic risk of loss is discussed below.

Direct Pledge

If a partner or a related person pledges his separate property (other than a direct or an indirect interest in the partnership) as security for the partnership liability, he is considered to bear the economic risk of loss for the partnership liability to the extent of the value of the pledged property. [Treas. Reg. § 1.752-2(h)(1)]

Indirect Pledge

If a partner contributes property to the partnership solely for the purpose of securing a partnership liability, he is considered to bear the economic risk of loss to the extent of the value of the contributed property. A property is not considered as contributed solely for the purpose of securing a partnership property unless substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner. This allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction. [Treas. Reg. § 1.752-2(h)(2)]

Valuation

For purposes of determining the economic risk of loss, the value of the directly or indirectly pledged property is based on its fair market value determined at the time of the pledge or contribution. [Treas. Reg. § 1.752-2(h)(3)]

Partner's Promissory Note

If a partner contributes his promissory note to the partnership as a security for a partnership liability, the promissory note is not taken into account unless it is readily tradable on an established market. [Treas. Reg. § 1.752-2(h)(4)]

5610 Valuation of Payment or Contribution Obligations- General Rule

The time-value of money has to be taken into account in determining the value of an obligation to pay or to contribute to the partnership.

The extent to which a partner or related person bears the economic risk of loss is determined by taking into account any delay in time when a payment or contribution obligation is to be satisfied.

If a payment obligation is not required to be satisfied within a reasonable time, or if the obligation to make a contribution to the partnership is not required to be satisfied before the later of:

- the end of the year in which the partner's interest is liquidated, or
- 90 days after the liquidation,

then the obligation is recognized only to the extent of the value of the obligation. [Treas. Reg. § 1.752-2(g)(1)]

PTM 5611 Valuation of An Obligation
PTM 5612 Satisfaction of Obligation with Partner's Promissory Note

5611 Valuation of An Obligation

If a payment or contribution obligation is not required to be satisfied within the time period specified under the general rule (See PTM 5610), the value of such obligation equals the entire principal balance only if the obligation bears interest equal to or greater than the applicable federal rate under § 1274(d) at the time of valuation, commencing on:

- in the case of a payment obligation, the date the partnership liability to a creditor becomes due and payable, or
- in the case of a contribution obligation, the date of the liquidation of the partner's interest in the partnership. [Treas. Reg. § 1.752-2(g)(2)]

In other words, if an obligation is not satisfied within the required time period, it has to bear interest in order for it to be taken at its face value. If the obligation does not bear interest at a rate at least equal to the applicable federal rate at the time of valuation, the obligation is discounted to the present value of all payments due from the partner or related person, using the imputed principal amount computed under § 1274(b). [Treas. Reg. § 1.752-2(g)(2)(ii)]

Note: Under § 1274(b), the imputed principal amount of any debt instrument equals the sum of the present value of all payments due under such instrument discounted at the applicable federal rated.

For purposes of determining the present value, the partnership is deemed to have constructively liquidated as of the day on which the payment obligation is valued. [Treas. Reg. § 1.752-2(g)(2)(ii)]

***Example**:*
John, the general partner, and Janet, the limited partner, each contributes $10,000 to J&J partnership. The partnership purchases a building for $90,000 from an unrelated seller, paying $20,000 in cash and signing a $70,000 recourse note. The partnership agreement provides that profits and losses are to be divided equally. Both John and Janet are required to make up any deficit in their capital accounts. However, while John is required to restore his deficit capital account within 90 days after the date of the liquidation of the partnership, Janet does not have to restore her capital account until two years after the liquidation date. In addition, Janet's deficit amount does not bear interest during that two-year period. The determination of John's and Janet's economic risk of loss is based on the constructive liquidation as follows:

	John	*Janet*
Initial contribution	*$10,000*	*$10,000*
Loss on hypothetical sale	*(45,000)*	*(45,000)*
Ending capital account	*(35,000)*	*(35,000)*

John and Janet's capital accounts each reflects a deficit of $35,000 which they have to restore. John has to make up his deficit capital account within 90 days from the liquidation date; therefore the obligation is taken at its face value, which is $35,000. With regard to Janet, she is not obligated to make up the negative capital account until two years after the liquidation. In addition, her obligation bears no interest. Therefore, the fair market value of her obligation is deemed to equal the imputed principal amount under § 1274(b). Assuming the federal rate with respect to Janet's obligation is 10% compounded semiannually, the fair market value of $35,000 discounted at 10% equals $28,795. This is the value of Janet's obligation to restore her capital account. Accordingly, Janet bears the economic risk of loss to the extent of the value of her contribution. With regard to John, since he is the sole general partner, he would be obligated by operation of law to contribute an additional $6,205 (35,000 - 28,795) to make up for Janet.

Therefore, John bears the economic risk of loss for $41,205 (35,000 + 6,205). As a result, the $90,000 recourse liability is allocated to John and Janet in the amounts of $41,205 and $28,795, respectively. [Treas. Reg. § 1.752-2(g)(4) Ex]

Note: The above example is modified after an example provided in the regulations. It not only illustrates the computation of the present value of the obligation to restore the deficit capital account, but also shows that a recourse liability is allocated to all partners, regardless of whether the partner is a general or a limited partner. In addition, in the above example, if Janet is not required to restore her capital account, she does not bear the economic risk of loss of anything beyond her initial contribution. As a result, the entire $90,000 recourse loan is to be allocated to John, the general partner.

5612 Satisfaction of Obligation with Partner's Promissory Note

An obligation is not satisfied by transferring to the obligee a promissory note by a partner or related person unless the note is readily tradable on an established securities market. [Treas. Reg. § 1.752-2(g)(3)]

5620 Recourse Liabilities In Tiered Partnerships

If a partnership (the upper-tier partnership) owns (directly or indirectly through one or more partnerships) an interest in another partnership (the lower-tier partnership), the liabilities of the lower-tier partnership are allocated to the upper-tier partnership in an amount equal to the sum of the following:

- The amount of the economic risk of loss that the upper-tier partnership bears with regard to the liabilities; and
- Any other amount of liabilities with respect to which partners of the upper-tier partnership bear the economic risk of loss. [Treas. Reg. § 1.752-2(i)]

***Example**:*
A and B forms AB partnership. AB partnership owns 20 percent interest in CD partnership. CD partnership has a $100,000 recourse liability and a $250,000 non-recourse liability. A pledges his own home as security for the non-recourse loan. At the time of the pledge, the fair market value of his home is $120,000. The liabilities of CD (the lower-tier) which are allocated to AB (the upper-tier) include 20 percent of the $100,000 recourse liability and $120,000 that represent the economic risk of loss A has to bear.

5630 Anti-abuse Rules

The general anti-abuse rule is provided in the 1991 Regulations to allow the government to disregard the form of a financing arrangement designed to allocate partnership liabilities to the partners that do not bear the economic risk of loss.

An obligation of a partner or related person to make payment may be disregarded or treated as an obligation of another person if the facts and circumstances indicate that the principal purpose of the arrangement between the parties is to eliminate the economic risk of loss of a partner with regard to an obligation or create the appearance of a partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. These circumstances include, but not limited to, the following situations: [Treas. Reg. § 1.752-2(j)(1)]

Arrangement Tantamount To A Guarantee

Regardless of the form of a contractual obligation, a partner is considered to bear the economic risk of loss with respect to a partnership liability to the extent that:

- The partner or related person undertakes one or more contractual obligations so that the partnership may obtain a loan;
- The contractual obligation of the partner or related person eliminates substantially all the risk to the lender if the partnership does not satisfy its obligation under the loan;
- One of the principal purposes of using the contractual obligation is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the bases of their partnership interests. [Treas. Reg. § 1.752-2(j)(2)]

PLAN TO CIRCUMVENT OR AVOID THE OBLIGATION

If the facts and circumstances indicate a plan to circumvent or avoid the obligation, a partner's obligation to make a payment may not be recognized. [Treas. Reg. § 1.752-2(j)(3)]

***Example**:*
A and B form a general partnership. A, a corporation, contributes $50,000 and B contributes $450,000. A is obligated to restore any deficit in its partnership capital account. The partnership agreement provides that losses will be allocated 10% to A and 90% to B until B's capital account is reduced to zero,

after which, all losses will be allocated to A. The partnership purchases a depreciable property for $5,000,000 paying $500,000 cash and borrowing $4,500,000 from a bank. The loan is a recourse liability since B guarantees payment of the $4,500,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. A is a subsidiary of another corporation, formed for the purposes of investing in the business activity with capital limited of $50,000. The agreement to allocate all losses to A after B's capital account is reduced to zero is to allow A to enjoy the tax loss generated by the property at the same time limiting its monetary exposure for such losses. These facts, when considered with B's guarantee of the loan, indicates a plan to circumvent or avoid A's obligation to contribute to the partnership. Even though the partnership agreement provides that A has to restore its deficit capital account, this obligation to contribute must be ignored. The entire $4,500,000 recourse liability has to be allocated to B who bears the economic risk of loss. [Treas. Reg. § 1.752-2(j)(4)]

5700 PARTNER'S SHARE OF NON-RECOURSE LIABILITY

For purposes of § 752, a non-recourse liability is a partnership liability for which no partner or related person bears the economic risk of loss (See PTM 5492). Therefore, the allocation of a true non-recourse liability cannot be determined based on the partners' economic risk of loss. Instead, partnership non-recourse liabilities are allocated among the partners in the following order: [Treas. Reg. § 1.752-3(a)]

- The partner's share of partnership minimum gain determined in accordance with the rules of § 704(b) and the regulations thereunder (See PTM 5710)
- The amount of any taxable gain that would be allocated to the partner under § 704(c) (or in the same manner as § 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more non-recourse liabilities of the partnership in full satisfaction of the partnership liabilities and for no other consideration (See PTM 5720); and
- The partner's share of excess non-recourse liabilities (those not allocated under the above two rules, i.e., § 704(b) and § 704(c).) The allocation of the excess non-recourse liabilities is in accordance with the partner's share of partnership profits or another method elected by the partnership provided this method meets the requirements under § 704(b) regulations.

The above three tiers apply to partnership non-recourse liabilities on a liability-by-liability basis. (See PTM 3071 for discussion of situations when a property is subject to more than one liability)

5710 Partnership Minimum Gain Under § 704(b)

- The amount of partnership minimum gain is the gain that a partnership would realize if it disposed of the property subject to that liability for no consideration other than in full satisfaction of the liability. [Treas. Reg. § 1.704-(2)(d)(1)]

- In general, the minimum gain amount is determined by subtracting the partnership's adjusted basis in the property from the balance of the encumbering liability. If the partnership's adjusted basis is more than the amount of the encumbering liability, there is no minimum gain and this rule does not apply.

- If a partnership property is reflected on a partnership's book at a value that differs from its adjusted tax basis, the determination of § 704(b) gain is based on the book value. [Treas. Reg. § 1.704-2(d)(3)]

Example*:*
GP (general partner) and LP (limited partner) formed a partnership in 1995. GP contributed $10,000 and LP contributed $90,000. The partnership agreement provides that losses would be allocated 10% to GP and 90% to LP (assuming the allocation has substantial economic effect (see PTM 1100*). Partnership AB bought a depreciable property in 1995 for $1,000,000, paying $100,000 in cash and the balance is financed through a non-recourse loan. As of December 31, 1996, the partnership's adjusted basis in the property is $800,000 (due to depreciation of $200,000) and the balance on the loan is $950,000. Assuming the partnership disposed of the building for no other consideration except to satisfy the non-recourse loan, the partnership would realize $150,000 in minimum gain. Under the "minimum gain chargeback" rule*[21]*, this gain would normally be allocated ("charged back") to the partners who took the (depreciation) deductions that created the minimum gain. Therefore, an amount of non-recourse liability equal to the minimum gain of $150,000 is allocated to GP and LP in accordance with their share of depreciation deduction on the property, which is 10% and 90%, respectively. [Treas. Reg. § 1.704-2(m), Ex. (1)] The remaining $800,000 of the non-recourse liability will be allocated according to the partners' profit ratio. (There is no § 704(c) built-in gain to be allocated in this case (See* PTM 5720.*)*

Note: The regulations under § 704(b) are discussed in PTM 1000 through PTM 1495.

5720 Partnership Minimum Gain Under § 704(c)

A partner's share of non-recourse liabilities includes the amount of any taxable gain that would be allocated to the partner under § 704(c) or in the same manner as § 704(c) if partnership property is revalued.

IRC § 704 (c) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. [IRC § 704(c)(1)]

If a partner contributes a property to a partnership, and at the time of contribution, the fair market value of the contributed property exceeds the partner's adjusted basis in the property, the excess amount is referred to as § 704(c) gain, or the built-in gain. It is a gain that the contributing partner would have recognized had he sold the property at its fair market value. The regulations under § 752 ensure that the contributing partner's share of the non-recourse liability encumbering the property he contributes should include this built-in gain.

Note: In Rev. Rul. 95-41, the IRS issued guidance on the effect of § 704(c) on the allocation of non-recourse liabilities under Regs. § 1.752-3(a).

Example:
Assume the facts are the same as the above example -, except that on December 31, 1996 a new limited partner is admitted into the partnership for a 50% limited interest in the partnership. The new partner contributes $50,000 in cash to the partnership. The partnership uses the cash as its working capital. The partners' interests in the partnership capital, profits, and losses are as follows: GP: 10%; Old LP (LP 1): 40%; and New LP (LP 2): 50%. Since a new partner is admitted, the partnership's property is revalued, which shows it has a market value of $1,000,000. The allocation of the $950,000 outstanding non-recourse liability among the three partners is as follows:

<u>Determining the amount of § 704(b) gain</u>
Under the general rule discussed in PTM 5700*), the first tier is the allocation of the minimum gain under §704(b), which reflects the excess of the outstanding liability over the partnership's adjusted basis in the property. The partnership tax basis in the property is $800,000. However, due to the revaluation, the book value of the property is "booked up" to$1,000,000, which reflects its market value. As discussed above (see* PTM 5710*), <u>when a property's book basis is different from its tax basis, the book basis is to be used for the purpose of computing the § 704(b) gain</u>. In the instant case, since the book basis ($1,000,000) exceeds the outstanding loan ($950,000), there is no §704(b) minimum gain.*

<u>Determining the amount of § 704(c) gain</u>
Under the rule discussed in PTM 5700*), the second tier of allocation includes the gain determined under § 704(c) or in the same manner as § 704(c) in connection with a revaluation of partnership property, which applies in this case due to the admission of a new partner. In general, the § 704(c) gain reflects the built-in gain the contributing partner should recognize if the partnership disposes of the property in full satisfaction of the encumbering liability. Therefore, the difference between the liability ($950,000) and the <u>tax basis</u> of the property ($800,000) which is $150,000 will be allocated to GP and LP 1 (which reflects the gain*

associates with their holding of the property during the years before LP 2 is admitted.) However, it should be noted that if the property is hypothetically sold for the balance of the liability, which is $950,000, it would generate a book loss of $50,000 (because the property's book value is $1,000,000). Depending on the methods the partnership adopts under § 704(c) rules, the partnership may allocate $150,000 minimum gain to GP and LP 1 under the traditional method or traditional method with curative allocation or allocate $200,000 ($150,000 minimum gain plus $50,000 remedial allocation) under the remedial method. [Revenue Ruling 95-41, 1995-23 IRB 5]

The excess non-recourse liability
Assuming the partnership adopts the remedial method and allocates $200,000 in § 704(c) gain to GP and LP 1 (according to their previous ratio 10/90), the excess non-recourse liability of $750,000 ($950,000 - 200,000) is allocated to GP, LP 1, and LP2 according to their profit ratio or a different method they agree upon provided this method meets the requirements under § 704(b) regulations.

5730 Non-recourse Liabilities In Tiered Partnerships

An upper-tiered partnership's share of the liabilities of the lower-tier partnership is treated as a liability of the upper-tier partnership for purposes applying § 752 (and the regulations thereunder) to the partners of the upper-tier partnership. The liability of the lower-tier partnership that is owed to the upper-tier partnership is not counted under this "flow-through" method.

Example:
Al contributes $10,000 in cash to AA partnership for a 10% interest in the partnership. Partnership AA invests $50,000 for 50% interest in Realty partnership. Realty partnership purchases an apartment building, incurring a non-recourse loan of $900,000.

Partnership AA's share of partnership Realty's liability is 50% of the $900,000 non-recourse loan, which is $450,000. Therefore, partnership AA's basis in Realty is $500,000 (consisting of its cash investment of $50,000 and $450,000 in its share of Realty liability). Al's basis in partnership AA is $55,000 (consisting of $10,000 in cash contribution and $45,000, his 10% share of AA's liability). [Revenue Ruling 77-309, 1977-2 CB 216]

5800 CASE LAW

5900 BASIS & LIABILITIES: POTENTIAL AUDIT ISSUES & TECHNIQUES

5910 In General

GATHERING THE FACTS IS THE MOST IMPORTANT STEP IN THE AUDIT PROCESS.

5920 Basis

Generally, auditors will need to know a partner's basis in their partnership interest, **especially** in the following situations:

- The partnership reports a loss on the Schedule K that flows through to partners.

  The issue is whether the partner has sufficient basis in his partnership interest to deduct the losses. A computation of basis should be made to determine the deductibility of the loss. If the partner does not have sufficient basis in their partnership interest, losses may be disallowed in the current year and suspended until the partner has enough basis to deduct the losses.

- The partnership distributes property or cash in a non-liquidating distribution.

  The issue is whether the distribution is taxable. (see PTM 6000) A computation of the partner's basis in the partnership should be made to determine the taxability of the distribution. If a distribution is in excess of a partner's adjusted basis in his partnership interest, the distribution may be taxable.

- The partnership is relieved of liabilities or has a decrease in liabilities. This would appear as other income on the Schedule K or on the Schedule L (balance sheet) as a decrease in liabilities.

  The issue is whether the decrease in liabilities creates a deemed distribution. If the audit determines that a deemed distribution occurred, taxable income must be reported. (see PTM 6000)

A schedule of basis should be requested from the **partner** since the partnership is not required to calculate basis for each partner. Once this is provided, a cursory check should be made by comparing amounts on the schedule of basis with the actual return and prior year Schedule K-1s.

If the partner does not provide a schedule of basis, the auditor has two options. The first option is to obtain Schedule K-1's from inception (if available) and calculate the partner's basis using the Schedule K-1's and canceled checks to verify contributions. The second option is to use the alternate method discussed at PTM 5240.

5930 At Risk Issues

Auditors should compute a partner's amount at risk if a loss has been reported on the **partner's** return. The audit issues and techniques are as follows:

For Real Estate Partnerships:

- If a liability (other than qualified non-recourse) is included in the at risk calculation, the auditor should verify that the **partner** is personally liable.

  The issue is whether the partner is actually liable for the debt. If the partner is not liable, it cannot be included in the amount at risk computation. If the partner does not have enough at risk, losses may be suspended until the partner does have enough at risk. Normally, the loan document or amendment to the loan document will substantiate that fact.

- If a non-recourse note is included in the at risk computation, verification should be made that the non-recourse financing is **qualified**.

  The issue is whether the non-recourse financing meets the criteria stated in PTM 5330. If the financing does not meet the criteria, it is not allowed to be included in the at risk computation. If the partner does not have enough at risk, losses may be suspended until the partner has enough at risk to deduct the losses. To determine if a note meets the criteria, the auditor should examine the loan documents. The loan documents will disclose who the lender is and the fact that it is actually a non-recourse note. Most loan documents will state the purpose of the loan (eg. construction or real estate).

For Non-Real Estate Partnerships:

- If a liability is included in the amount at risk, the auditor should verify that the **partner** is personally liable.

  The issue is whether the partner is actually liable for the debt. If the partner is not liable, it cannot be included in the amount at risk computation. Normally, the loan document or amendment to the loan document will state whether an individual partner has guaranteed the note.

5940 Audit Issues Involving Partnership Liabilities

Determining a partner's share of partnership liabilities, or a relief thereof, is an important part of the determination of a partner's basis in his partnership interest. (see PTM 5920) In some situations, the determination of a partner's share of partnership liabilities may be complicated. Though the regulations promulgated under § 752 are lengthy and complex, the auditor needs to understand them thoroughly to determine if the partnership's allocation of its liabilities is in compliance with the law. This section provides some guidelines on the areas the auditor may want to examine and certain audit techniques.

In general, an examination of a partner's share of partnership liabilities should include the following:

- Determining if the liability is a partnership liability.
- Determining if the liability is a recourse or non-recourse liability.
- Examining the allocation of the liability to partners.
- Examining the valuation of the partner's obligation to contribute or to make a payment.

Though there is no requirement that all of the above areas have to be thoroughly examined in each case, the auditor should be able to make a determination based on the provided documents. If the auditor decides to pursue an area further, he may want to consider the following factors before and during the audit:

- Materiality: An examination of § 752 issues may be time consuming due to the potential amount of documents to be reviewed. The auditor needs to determine in advance the materiality of the issue and the estimated time to resolve the issue.

- Audit Scope: An examination of a partner's share or relief of partnership liabilities may be complicated in some situations. The auditor needs to exercise judgment to limit or expand the scope of his examination based on the facts and circumstances. For instance, if a partner transfers a portion of his partnership interest to another partner, the issue may be limited to the tax effects of the relief of liability on the transferring partner. However, if the transferring partner claims that he remains liable for the liability associated with the transferred interest, the auditor may have to expand the examination to determine if the partner's claim is valid. In other words, the auditor needs to constantly evaluate the scope of his examination based on the facts and circumstances of the case.

5950 Audit Issues-Is the Liability A Partnership Liability?

In order for a liability to be allocated to the partners, it has to be a partnership liability for purposes of § 752 (see PTM 5431) In most situations, there is compliance in this area. Generally, the auditor may be able to determine if a liability is a § 752 liability based on a review of the loan document. However, there are several issues identified in this area.

<u>Accounts Payable</u>

Facts: The taxpayer computes his insolvency for purposes of § 108. He includes his proportionate share of partnership's accounts payable. The accounts payable relates to partnership's purchase of its inventory. The partnership is on a cash accounting method.

Issue: If a partnership uses a cash accounting method, its account payable may not be considered a § 752 liability and the partners cannot increase their partnership's bases by their share of the account payable. (see PTM 5432).

Techniques: The auditor needs to verify the partnership's accounting method as reported on Form 565, line G. (If there is a change in the partnership's accounting method during the year, the auditor needs to examine the tax consequences of the change as well as its impact on the partnership's account payable. [See, e.g., §§ 481(a), 446 and the regulations thereunder.] Also, request the taxpayer's explanation of the inclusion of such amount in his basis.

Contingent Liabilities

Issue: There are a number of cases where the taxpayers include their share of certain partnership liabilities which appear to be contingent liabilities for purposes of §752, particularly when the partners compute their insolvency under § 108. Whether a liability is contingent depends on the facts and circumstances (see PTM 5434). It should also be noted that a liability required to be reported for financial purposes does not necessarily constitute a liability for tax purposes or § 752 purposes.

Techniques: The auditor needs to request all documents related to the said liabilities and determine whether they meet the requirements of § 752 (see PTM 5431) or if they meet the "all event" test (see PTM 5434).

Note: There are no cases or IRS guidance regarding the inclusion of contingent liabilities in the insolvency computation.[22] For instance, when a limited partner guarantees a partnership liability and the partnership as well as other partners are insolvent, should the limited partner be allowed to include the liability in his insolvency computation?

Loans by Partners

Issue: If a partner or his related person makes a non-recourse loan to the partnership, the loan is characterized as a recourse loan and allocated to the lending partner (see 5440). (There are exceptions.) A loan from a partner may also arise out of the sale of a property by a partner to the partnership.

Techniques: Based on the loan documents, the auditor should be able to determine whether or not the loan is a non-recourse loan from a partner. Check if the exception rules apply. Also, the auditor should analyze the tax effects of the liability reallocation on all partners, such as limiting losses or recognizing gain from a distribution exceeding basis.

Loans or Capital Contributions

Issue: As discussed in PTM 5450, a partner's loan may be recharacterized as a capital contribution or vice versa, based on the facts and circumstances of each particular case. In some situations, a partner may want to recharacterize a capital contribution as a loan to obtain the benefit of deducting a bad debt when the partnership is not capable of repaying its debt. If the loan is in essence a capital contribution, the partner's bad debt deduction may be disallowed and the loss from a capital contribution may not be recognized until the partnership liquidates. In other situations, a partner may want to characterize a loan as a capital contribution to obtain additional basis in his partnership interest.

Techniques: Again, whether an advance of money is a loan or a capital contribution depends largely on the facts and circumstances. The auditor needs to obtain all related documents and make a determination accordingly. Please note that the government may be allowed to recharacterize a partnership transaction based on its substance while the taxpayers are generally bound by the form of the transaction they selected though they might have intended differently.

Partner's Assumption of Partnership Liabilities

Issue: A partner's assumption of partnership liabilities may occur in a number of situations, e.g., when a property encumbered with liability is distributed to a partner. Also, when a partner's status changes from being a general partner to a limited partner, he may or may not remain liable for certain partnership liabilities that he previously assumed as a general partner.

Techniques: The purpose of the examination is to determine if the partner's assumption is valid. The auditor needs to consider a number of factors such as the partner's status, the type of partnership liabilities, the financial agreements and arrangements among the lender, the partnership, and all partners, etc. The auditor should also be aware of certain limitations regarding the amount assumed and the conditions for the assumption (see PTM 5460). In addition, the auditor may want to know what happened to the liability after it was assumed by the partner, e.g., if the partner made any payments on interest and principal of the loan, etc..

Netting of Increases and Decreases in Liabilities

Issue: In general, all increases and decreases in a partner's share of partnership liabilities are netted if they are from a single transaction (see PTM 5470). The issue is to determine which increase or decrease is associated with a transaction. Also, the issue may be to determine what constitutes a "single transaction" for netting purposes.

Example: Corporation A is an equal partner in partnership AB. The partnership owns a building that is rented by A. For various tax planning purposes (which are irrelevant in this example) the following "transactions" occur at the same time:

- The partnership refinances its old mortgage on the building with a new mortgage;
- The partnership distributes both the building and the new mortgage to B, the other corporate partner; A receives nothing but the right to lease the building;
- B sells the building to the bank (mortgage holder) in cancellation of the outstanding mortgage;
- The bank leases the building to A subject to certain requirements so that for income tax purposes, A is treated as owner of the property and enjoys all the tax benefits associated with such ownership (e.g., deduction for depreciation, interest expenses, etc.)

There is no issue with the leasing arrangement in this case. However, the main issue is at the time of the partnership liquidation, A has a very large negative capital account that is not restored when the partnership liquidates. Since both the building and the mortgage are distributed to B, A's share of the partnership liability is decrease which constitutes a deemed cash distribution to A. Therefore, the negative capital account represents the potential gain A has to recognize. However, A argues that it has no gain on the partnership liquidation because the relief of liability from the liquidation is netted with the liability A assumes when it leases the building from the bank. The basis for netting the decrease and increase in liabilities, according to A, is because the partnership liquidation and the lease of the building are merely "steps" in a single transaction aiming at transferring the building and the mortgage to A.

As it could be seen, the issue with this case is what constitutes a "single transaction": whether the liquidation of the partnership, the sale of the building, and the subsequent lease can be treated as steps in a single transaction or separate and distinct transactions with their own tax consequences. Though A's arguments may be challenged under the "step transaction' theory, this case is an illustration of a potential issue with the netting rule.

Techniques: In cases similar to the above, the auditor needs to develop all the facts and circumstances and make a determination based on case law precedence.

5960 Audit Issues- Is the Liability Recourse or Non-recourse?

After determining if a liability is a partnership liability for § 752 purposes, the auditor needs to verify if the partnership's liabilities are correctly characterized as recourse or non-recourse.

- A partnership liability is a recourse liability if any partner (or a related person) bears the economic risk of loss for the liability. (see PTM 5490) An economic risk of loss is determined using the constructive liquidation test. (see PTM 5510) In essence, this test determines the amount a partner has to contribute to the partnership to satisfy the partnership creditors if all of the partnership assets become worthless.

- A non-recourse liability is a liability for which no partner (or a related person) bear the economic risk of loss (see PTM 5492).

In most situations, the auditor should be able to determine whether a loan is recourse or non-recourse based on the terms of the agreements between the lender and borrower. For instance, in a non-recourse loan agreement, the lender's recourse is usually limited to taking the collateral by power of sale under the deed of trust and no deficiency judgment can be obtained even if the value of the collateral is less than the amount of the liability. On the other hand, if a lender may obtain a deficiency from the debtor and the general partners, the liability is recourse.

In addition, a loan may also be recourse or non-recourse based on the lender's rights under state law. For instance, a loan incurred in connection with the purchase of a personal residence in California is non-recourse by virtue of California law. [Cal. Code Civ. Proc. § 580b]

The problem with distinguishing recourse from non-recourse is when the loan agreement is silent with regard to borrower's "personal liability". In this situation, the auditor should look at the type of loans. For instance, if the loan is a personal loan, not secured by any property, the loan should be treated as recourse since the lender has no other recourse except to look at the borrower as a source of repayment. If the loan is secured by a property and there is no expressed provisions regarding personal liability, the loan is generally non-recourse since the lender's only recourse is to foreclose on the securing property. Please note that even in a non-recourse loan, a borrower may be liable for certain items such as intentional misrepresentation and fraud, environmental indemnity, waste, etc.

Techniques: The auditor should consider the purposes of all loans, the partnership business, and the underlying operation of state law. In addition, it is helpful if the auditor has copies of all loan agreements, side agreements, and modifications.

5970 Audit Issues- Determining Partner's Share of Partnership Liability

Applicable Regulations

The sharing of recourse and non-recourse liabilities is provided in three different sets of regulations with different effective dates (see PTM 5480). The application of these regulations to a liability is based on the date the liability is incurred, unless the partnership makes an election to apply differently. Though the underlying sharing principle is the same in all three sets of regulations, the new regulations provide more clarification and restrictions on the allocation of partnership liabilities.

In reviewing a partnership liability, the auditor may want to verify if the allocation of such liability is in compliance with the applicable regulations.

Sharing of Recourse Liabilities

To determine a partner's share of recourse liability, the auditor should perform the following tasks:

- *Determining a partner's economic risk of loss*: A partner's share of partnership recourse liabilities under the final regulations is based on his economic risk of loss. The determination of a partner's economic risk of loss is made under a hypothetical liquidation in which the partnership's assets were disposed of for no value and the resulting loss is allocated to the partners according to their loss sharing ratio. This allocated loss causes the partners' capital account to be negative. Each partner's negative capital account represents the amount he has to contribute to the partnership or to the creditor to satisfy the liability, which is also referred to as his "economic risk of loss". As a result, the partner is allocated all or a portion of the partnership recourse liabilities equivalent to this economic risk of loss amount, provided the obligations determined under this hypothetical liquidation meet the requirements discussed below. (see Examples in PTM 5520)

- *Valuation of the Obligations*: The hypothetical liquidation helps determine each partner's obligation to contribute or to make payment. To what extent these obligations are recognized depends on the facts and circumstances at the time of the determination. The new regulations provide various rules regarding the valuation of an obligation to make payment or contribution (see PTM 5530, PTM 5610). For instance, contractual obligations outside the partnership agreement such as guarantees, reimbursement agreement, etc. entered into by the partners, creditors, or the partnership are recognized. Contingent obligations are not recognized. (see PTM 5531) Also, if an obligation is not satisfied within the time period specified in the law (see PTM 5610), the value of such obligation is computed based on its present value rather than its face value (see PTM 5611).

The auditor needs to verify if the obligations are in compliance with the rules provided in the regulations. Any allocations that are different from the amounts determined in the above process should be revised.

Note: In general, for purposes of determining the partner's economic risk of loss and his obligations, it is assumed that the partner is capable of satisfying these obligations, regardless of his financial situation, unless the facts and circumstances indicate a plan to circumvent or avoid the obligations (see PTM 5533)

Sharing of Non-recourse Liabilities

In general, a partner's share of non-recourse liabilities is based on three tiers (see PTM 5700): § 704(b) minimum gain, § 704(c) gain, and the excess non-recourse gain. Due to the complexity involving § 704(b) and (c) regulations, the potential issues involving non-recourse liabilities are discussed in PTM 2000 through PTM 3500.

Techniques

When to audit? The most commonly asked question is in what situation should an auditor need to verify the allocation of partnership liabilities? The general answer is whenever there is a need to determine a partner's basis in the partnership. The need to determine a partner's basis may arise when a partner is allocated partnership losses, distributed partnership property, or when there is a change in the ownership of partnership interest (through a sale, gift, retirement, admission of new partners, etc.)

As mentioned earlier, the determination to examine the liability allocation should be based on materiality and the time it takes to complete the examination.

Entity vs Investor Level: The need to examine the sharing of partnership liabilities may arise due to various reasons, e.g., an admission of a new partner into the partnership, a special allocation of certain partnership items of income or losses to certain partners, etc. Currently, there is no guideline on whether the auditor should conduct the examination at the partnership or the partner level. It is up to the auditor's judgment to determine the scope and the extent of his examination based on the facts and circumstance of each case. For instance, if the schedule K-1 shows a limited partner being allocated a partnership recourse liability, the auditor may start his examination at such partner's level and request supporting evidence. However, if as a result of his examination, it is determined that the liability may have to be reallocated to other partners, the auditor may contact the partnership for additional information.

Note: Under the TEFRA rules, the amount, character and changes in partnership liabilities are treated as "partnership items" and should be determined at the partnership level. [See § 6231 and the regulations thereunder]

What documents to request? As a general rule, the auditor should have the following documents available for review:

- Partnership agreements and all amendments.
- All loan agreements, including all side agreements between the creditor and the partners.
- All agreements between the partners outside the partnership agreement.
- A schedule computed by the partnership showing how the partnership liabilities are allocated among the partners. Also, request the partnership to provide detailed explanation of its allocation and the authority supporting its allocation.

What to look for:

First, the allocation of partnership liabilities on the schedule computed by the partnership should match the amounts reported on the schedule K-1 issued to each partner.

Second, the auditor should verify the partnership's computation of its partners' economic risk of loss under the hypothetical liquidation. This verification should include a review of the partnership's total assets as reported on the Schedule L (Form 565), the balance of the liabilities immediately prior to the event that triggers the needs to examine the liability allocation, and the loss sharing ratios as stated in the partnership agreement.

Third, once the auditor is satisfied with the computation of the partners' economic risk of loss, he needs to evaluate the obligations to contribute or to make payment by verifying if the partners are required to timely restore their negative capital accounts as provided in the partnership agreement, or if there are any side agreements among the partners regarding reimbursement, indemnification, etc.

5980 Audit Issues- Valuation of an Obligation

The constructive liquidation test is to determine a partner’s obligation to contribute to the partnership or to make a payment to any person (another partner or the creditors of the partnership). Whether or not an obligation is respected depends on facts and circumstances at the time of the determination. The § 752 regulations are specific about what obligations are recognized for purposes of § 752 (see PTM 5530). The auditor needs to be aware of these requirements and determine if the obligations meet these requirements.

The Anti-abuse Rules: The law provides that any obligations determined above may be disregarded if the facts and circumstances indicate a plan to eliminate certain partner’s economic risk of loss or create the appearance of an economic risk of loss for certain partner (see PTM 5630). The auditor needs to evaluate all of the partnership’s arrangements and contractual obligations as a whole and determine the substance of these arrangements.

6000 DISTRIBUTIONS

6010 DISTRIBUTIONS FROM A PARTNERSHIP-GENERAL

Partnership distributions are covered in IRC §§ 731, 732, 733, 734 & 735. Auditors should consider the effects of IRC§§704(c)(1)(B), 707(a)(2), 737 and 311(b) when analyzing the consequences of a distribution under IRC § 731.

Distributions from a partnership are common and therefore the determination of the tax ramifications is important. Distributions are important from a compliance standpoint because generally, a distribution of property is "tax free". There are several exceptions to the general rule. Gain or loss may be recognized in the following situations:

- in a current or liquidating distribution, if money distributed exceeds the partners' adjusted basis in their partnership interest. (See PTM 6120)
- in a current distribution, the partnership distributes "marketable securities". (See PTM 6400)
- in a liquidating distribution, a loss may be recognized if the distribution consists of money, unrealized receivables or inventory (or any combination of the foregoing) and the amount of money and the basis to the distributee of the unrealized receivables and inventory is less than the adjusted basis of his partnership interest prior to the distribution. (See PTM 6500)
- a partner contributes property and that property is distributed to another partner or a distribution of other property to the contributing partner. This transaction may be treated as a sale or exchange. (See PTM 4500)
- if a partner's individual are assumed by the partnership or a partner's share of partnership liabilities are reduced, the assumption or reduction is treated as a distribution of money. If the constructive distribution of money exceeds the partner's basis in his partnership interest, the partner will recognize gain.

The basis of the distributed property must be computed. If the basis is not computed correctly, there may be issues with respect to both depreciation and the subsequent sale of the property.

The character of gain or loss that results from the sale of distributed unrealized receivables or inventory is ordinary income or loss. (See PTM 6595)

A loan from a partnership to a partner may be recharacterized to a distribution from the partnership. (See PTM 6585)

6020 CALIFORNIA CONFORMITY

In general, California conforms to IRC §731- 735 with minor exceptions. The exceptions will be discussed in detail in each corresponding section, when appropriate. The Taxpayers Relief Act of 1997 contained the following Subchapter K changes for federal purposes:

- Allocation of basis among properties distributed by partnership (§732, §751)
- Repealed requirement that inventory be substantially appreciated with respect to disposition of partnership interest.
- Extended time for taxing pre-contribution gain. (§737(b))
- Closing partnership year with respect to a deceased partner. (§706)

Most of these federal changes were effective when the federal law was passed, 8/5/97. However, California conformed to the Taxpayers Relief Act of 1997 for tax years beginning on and after 1/1/98 and transactions occurring after that date.

6100 CURRENT DISTRIBUTIONS V. LIQUIDATING DISTRIBUTIONS—DEFINITIONS

Once the transaction has been categorized as a distribution, it must be determined whether it is a "current" or a "liquidating" distribution, since different sets of rules apply to each.

A distribution in liquidation of a partner's interest is defined by Regulations §1.761-1(d) to mean "the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions." This Regulation also provides that a "series" of liquidating distributions may span more than one tax year.

The distributee's entire interest must be liquidated. If a partner is both a general and limited partner, both the general and limited partnership interests must be liquidated in order for distributions to be characterized as liquidating distributions. [Delwin G. Chase, 92 TC 874 (1989); cf. Revenue Ruling 84-53, 1984-1 CB 159]

A current distribution is defined by exclusion as any distribution that is **not** a liquidating distribution.

- Therefore, a distribution may be pro rata or disproportionate, large or small, in-cash or in-kind, and still be a current distribution, if it does not completely terminate the distributee's interest and is not one of a series of liquidating distributions that will result in the termination of the distributee partner's interest.
- It may substantially reduce the distributee's interest, as long as the distributee retains some interest in the partnership. For example, a distribution that reduces a partner's interest from 99 percent to 1 percent is a current distribution.

6110 Current Distributions-General

- Under IRC §731(b), a partnership does not recognize gain on a distribution of money or other property to a partner. Similarly, the distributee partner does

not recognize gain upon the partnership's distribution of property other than money in excess of a partner's adjusted basis in his partnership interest (except for a property distribution to a contributing partner and situations encompassed by IRC §§704(c)(1)(B), 707(a)(2), 731(c), 737 and 751(b). {See PTM 6441, and PTM 4500}). [IRC § 731(a)(1)]
  - The fair market value of marketable securities is considered "money" for purposes of IRC §731(a)(1). [IRC § 731(c)] (For California purposes, applicable after 1/1/97)

- A distributee partner's basis in property distributed in a nonliquidating distribution is generally the lesser of the partnership's adjusted basis in the distributed property or the partner's adjusted basis in the partnership interest (reduced by any money distributed in the transaction). [IRC § 732(a)]

- A distributee partner's adjusted basis in his partnership interest is reduced by the amount of money and the basis of property distributed to him in a nonliquidating distribution. [IRC § 733]

- A loss is **never** recognized by the distributee partner or the partnership in connection with a current distribution of cash or property. [IRC § 731(a)(2)]

- Many partnership distributions will consist of partnership income that has already been taxed to the partners or returns of partnership capital, neither of which should be subject to further tax.

- When the partner ultimately sells the property, the carryover basis will be used to calculate any gain that must be recognized.

6120 Taxable Current Distributions

The following current distributions may be taxable:

- A current money distribution in excess of a partner’s basis in his partnership interest. [IRC § 731(a)(1)]
  - If a partner’s share of partnership liabilities decreases, or a partnership assumes a partner's individual liability(ies), a constructive cash distribution of money occurs under IRC §752(b). (See example below)
  - If a partnership distributes marketable securities, the marketable securities are considered money. [IRC § 731(c)] (See PTM 6400) (**Applicable for California purposes for tax years beginning on or after 1/1/97**)

- A partnership distributes property that had been contributed by another partner. If the property is distributed within seven years of the contribution, the partnership is treated as having sold the property at the time of distribution. (See PTM 4500)

Example:
J is a 40% partner in Picture Perfect Partnership (PPP). His adjusted basis in his partnership interest on January 1, 1995 is $20,000. On December 31, 1995, he received a $10,000 cash distribution in partial liquidation of his interest in PPP. His interest decreased from 40% to 20%. PPP has $100,000 in recourse liabilities, of which $40,000 had been allocated to J. When J's interest in PPP decreased to 20%, his share of the liabilities decreased to $20,000. J must recognize a gain of $10,000 ($10,000 cash distribution plus $20,000 deemed cash distribution from decrease in liabilities less $20,000 adjusted basis in partnership interest) on the partial liquidation.

6130 Advances or Draws versus Distributions

- If the tax consequences of a cash distribution are determined when the distribution is made, the partner may be required to recognize taxable gain even though economically he has not realized gain.

- Partnership income or loss is not reflected in basis until the close of the partnership's taxable year. [IRC § 706(a), Treas. Reg. § 1.705-1(a)] A cash distribution may represent a distribution of the current year's income and, therefore, would not represent economic gain to the partner.

- An advance or draw against a partner's distributive share of income is not treated as an immediate distribution, but are deemed to be current distributions made on the last day of the partnership's taxable year. [Treas. Reg. § 1.731-1(a)(1)(ii)]

- This regulation allows a partner to increase his basis in his partnership interest by his distributive share of partnership income before taking the advance or draw into account, therefore decreasing the chance that the distribution of money will be a taxable event. [Treas. Reg. § 1.731-1(a)(1)(ii)]

- Neither the Code nor the Regulations define advance or drawings. However, it appears the distributee must be required to return the draws or advances if they ultimately exceed the partner's share of partnership income for the year.

[See Rev. Ruling 81-241, 1981-2 C.B. 146, Rev. Ruling 81-242, 1981-2 C.B. 147, Tym Seay, 63 TCM]

Example:
P is an equal partner in Pat's Flowers, a general partnership. P has basis in his partnership interest of $0 at the start of the partnership's tax year. P's distributive share of partnership income for the year is $30,000 (which is earned ratably over the year). The partnership distributes $2,000 a month in cash to P during the year. If the monthly payment is treated as a draw against P's distributive share of income for the year, P would not incur any tax as a result of the distributions. See Treas. Reg. § 1/731-1(a)(ii). If the distribution is not treated as an advance or draw, P will be required to recognize $24,000 of capital gain under IRC §731(a) since he received $24,000 of cash distributions in excess of his $0 basis in his interest prior to the end of the year. In either event, P will also be taxable on his $30,000 distributive share of partnership income. If the $24,000 of cash distributions are treated as draws, i.e. as though they were made on the last day of the partnership tax year, P will be allowed to first increase his basis in his partnership interest by his $30,000 distributive share of partnership income before the distribution is taken into account. In that event, the $24,000 in distributions will not be subject to tax under IRC §731(a) and P will only be taxed on his $30,000 distributive share of partnership income.

6140 Basis of Property in Current Distributions

- Under the general rules, the distributee-partner's basis for property received in a current distribution is the same as the basis of the property in the hands of the partnership immediately prior to the distribution. [IRC § 732(a)(1)]
- In the case of a current distribution of marketable securities for which gain is recognized under IRC §731(c), the basis of the distributed marketable securities is increased, over his basis as determined under IRC §732, by the amount of gain recognized. [IRC § 731(c)(4)(A)]
- The basis increase is allocated among the distributed marketable securities in proportion to his respective amounts of unrealized appreciation (determined before the increase). [IRC § 731(c)(4)(B)]
- The general carryover basis rule of IRC §732(a)(1) does not apply if the distributee partner does not have sufficient basis in his partnership interest, as reduced by any money distributed in the same transaction, to fully absorb the partnership's basis in the distributed property.
    - o IRC §732(a)(2) limits the distributee's basis in the distributed property to his predistribution basis in his partnership interest, after

reducing said basis by any money distributed in the same transaction.

- If a partnership distributes more than one asset in-kind and the distributee partner does not have adequate basis in his partnership interest to absorb all of the partnership's basis in the distributed assets, IRC §732(c) sets forth the rules that govern the allocation of basis among the distributed assets. The rules are applied in the following manner:
  1. The distributee's basis in his partnership interest is first reduced by the amount of any cash distributed. [IRC § 733; Treas. Reg. § 1.733-1.]
  2. If the partner's remaining basis in his partnership interest is greater than the partnership's basis in inventory and unrealized receivables, the partnership's basis in those items is carried over to the distributee and the distributee's basis in his partnership interest is accordingly reduced. If the partner's remaining basis in his partnership interest is less than the partnership's basis in distributed unrealized receivables and inventory items, this remaining basis is allocated among the unrealized receivables and inventory items in proportion to the bases of these assets in the hands of the partnership. [IRC § 732(c)(2); Treas. Reg. § 1.732-1(c)(2).] In that event, any other class of property distributed along with the unrealized receivables and inventory would receive a basis of zero.
  3. If the distributee's basis in his partnership interest is not totally absorbed by the cash, unrealized receivables and inventory items distributed, the remainder of the distributee's basis is allocated to any other properties distributed in the same transaction in proportion to the basis these properties had in the hands of the partnership.

Example 1:
AB Partnership distributes property to C with an adjusted basis of $100,000. C's adjusted basis in the partnership is $50,000 prior to the distribution. C's basis in the property becomes $50,000 [IRC § 732(a)(2)] while her basis in her partnership interest is reduced to $0. [IRC § 733] If the general rule of IRC §732 was applicable, AB's $100,000 basis would carry over to C and the $50,000 gain would go unrecognized since IRC §733 prohibits a reduction in C's basis in AB Partnership below zero. The gain is unrecognized since IRC §731(a)(1) provides that in the case of a distribution, gain is only recognized where the amount of distributed "money" exceeds the recipient partner's outside basis.

Example 2:
A is a partner in a partnership and receives a current distribution consisting of $50,000 cash, inventory with an adjusted basis of $60,000 to the partnership and two pieces of real property, parcel 1 and 2, with bases to the partnership of $60,000 and $20,000 respectively. A's adjusted basis in the partnership is $150,000. The $50,000 cash distribution reduces A's interest from $150,000 to $100,000. This remaining basis is first allocated to inventory, which receives a carryover basis of $60,000 reducing A's basis in the partnership to $40,000 (100,000 basis in partnership interest less $60,000 basis in inventory). The remaining $40,000 basis is allocated to real properties 1 and 2 in proportion to his basis in the hands of the partnership prior to the distribution. Therefore, parcel 1, which had a basis of $60,000 (60,000 x 60,000/80,000 = 3/4), takes a $30,000 basis (3/4 of $40,000) in As hands. Parcel 2, which had a $20,000 basis, takes a $10,000 basis (1/4 of $40,000). A's basis in her partnership interest is decreased to zero.

6150 Partnership Terminations-General

When a partnership technically terminates per IRC §708, the termination does not cause the partners to recognize gain as a result of a deemed distribution of the partnership's marketable securities. [Treas. Reg. § 731-2(g)(2)]

<u>Terminations as of May 1, 1997</u>

California conforms for tax years beginning on or after 1/1/98.

If a partnership terminates as a consequence of the sale or exchange of 50% or more of the total interests in partnership profits and capital during a twelve month period under IRC §708(b)(1)(B), the following is deemed to have occurred:

- The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and
- Immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and other remaining partners in proportion to their respective interest in the terminated partnership in liquidation of the terminated interest. [Treas. Reg. § 1.708-1(b)(iv)]

<u>Terminations prior to May 10, 1997:</u>

If a partnership terminated under IRC §708(b)(1)(B) prior to May 10, 1997 (Prior to 1/1/98 for California purposes) the following is deemed to have occurred:

- The assets of the partnership are viewed as distributed from the old, terminated partnership to the partners; and
- The assets are immediately contributed by the partners to a new partnership. [Treas. Reg. § 1.708-1(b)(iv)]

6160 Current Distributions Of Special Basis Property- General

- The general rule set forth in IRC §734(a) is that the adjusted basis of partnership property is not adjusted as result of a distribution by the partnership to a partner.
- Under certain circumstances, a discrepancy may arise between the partnership's adjusted bases in its assets and the partners' adjusted bases in their partnership interests. The discrepancy may arise following a distribution in which the distributee partner recognizes a §731 gain or loss or in which the partner's adjusted basis in the distributed property in greater than or less than the partnership's adjusted basis in the property immediately preceding the distribution.
- These discrepancies create disparities in the amount and timing of income. For example, if a partner's interest is liquidated for cash, the partner will recognize gain equal to the excess of the cash received over the partner's adjusted basis in his partnership interest. The gain represents the partner's share of the appreciation in the partnership's assets. However, absent a basis adjustment, upon a subsequent sale of the assets by the partnership, the remaining partners will be subject to tax on the same gain.
- This subject is discussed in more detail in PTM 6240.

6200 LIQUIDATING DISTRIBUTIONS

6210 Liquidating Distributions-General

A liquidating distribution includes a single distribution [IRC § 761(d)] or a series of distributions that result in the termination of the distributee partner's entire interest in a partnership interest. [Treas. Reg. § 1.761-1(d)]

Each distribution in the series of liquidating distributions is considered to be a liquidating distribution although the partner's interest in the partnership whose interest is to be liquidated is not considered to be liquidated until the final distribution has been made. [Treas. Reg. § 1.761-1(d)]

Distributions in liquidation of a partner's interest in partnership property result in gain recognition to the distributee partner **only if** the amount of money distributed exceeds his adjusted basis in his partnership interest immediately before the distribution. [IRC § 731(a)(1); Treas. Reg. § 1.731-1(a)(1)] This must be coordinated with IRC§§736 and 751(b).

- The fair market value of marketable securities distributed is treated as "money." [IRC § 731(c)] (applicable for California purposes for tax years beginning on or after 1/1/97)

A loss may be recognized by the distributee partner on the liquidation of his entire interest in a partnership if the property distributed consists solely of one or more of the following: **money** (not including marketable securities), **unrealized receivables** (as defined in IRC §751(c)), and **inventory items** (as defined in IRC §751(d)). [IRC § 731(a)(2)]

- If a loss is recognized, it is equal to the excess of the distributee's predistribution basis less the amount of money and adjusted basis of unrealized receivables and inventory items distributed to that partner.

Any gain or loss recognized under IRC §731 is treated as gain or loss from the sale or exchange of a capital asset. [Miller v. United States, 331 F2d 854 (Ct. Cl. 1964); Neil O'Brien, 77 TC 113 (1981)]

Provided that IRC §731 controls the tax consequences of the transaction, a partnership does not recognize a gain or loss in connection with a distribution of partnership property in liquidation of a partner's interest. [IRC § 731(b); Treas. Reg. § 1.731-1(b)]

The following examples are based on the fact that IRC §731 alone controls the tax consequences of the transactions described therein.

Example 1:
A has decided to retire from AB Partners in December 1997. A's basis in AB Partners is $100,000 prior to any distributions. AB Partners distributes $50,000 in cash and $20,000 of inventory in a liquidating distribution. A recognizes a capital loss in the amount of $30,000.

Example 2:
J has an adjusted basis in his interest in partnership XYZ of $10,000. J retires from the partnership and receives in return for his share of partnership property $5,000 in cash and inventory with a basis to the partnership of $3,000. J recognizes a capital loss of $2,000.

If, in addition to the cash and inventory, J also receives real property with a value and an adjusted basis to the partnership of $1,000, J will not be entitled to recognize a loss. In that case, since J received property other than money, unrealized receivables and inventory items, the loss may not be recognized under § 731(a)(2).

6220 Basis of Property Received-General Rules

IRC §732(b) provides that the basis of property distributed by a partnership to a partner is equal to the partner's basis in their partnership interest immediately prior to the distribution reduced by any cash received in the same transaction.

If a partnership distributes more than one asset in-kind in complete liquidation of a partner's interest and the distributee partner does not have adequate basis in his partnership interest to absorb all of the partnership's basis in the distributed assets, IRC §732(c) sets forth the rules that govern the allocation of basis among the distributed assets. The rules are applied in the following manner:

1. The distributee's basis in their partnership interest is first reduced by the amount of any cash distributed.

2. The distributee's basis is then allocated to and reduced by, unrealized receivables and inventory.
3. The remaining balance (if any) is allocated to other property.

6221 Distributions prior to August 5, 1997

California conformed to IRC §732(c) for tax years prior to 1/1/98. This means, prior to the federal change effective for distributions after 8/5/97, both California and federal provided that the basis be allocated as discussed below.

The basis to be allocated to the unrealized receivables and inventory that are distributed cannot exceed the partnership's predistribution basis in those assets.

- If the total basis to be allocated is less than the partnership's basis in the unrealized receivables and inventory, the distributee partner's basis is allocated entirely to the unrealized receivables and inventory in proportion to his adjusted basis in the hands of the partnership. [IRC § 732(c)]
- Any other property distributed receives a zero basis.

If the basis to be allocated among the distributed properties exceeds the partnership's basis in distributed unrealized receivables and inventory, the balance of the basis is allocated to the other properties distributed in proportion to their adjusted basis to the partnership.

The basis allocation rules for a liquidating distribution are similar to those of a current distribution with the following exception.

- If a partner receives a current distribution of partnership property, the basis of the distributed property in the hands of the distributee may not exceed the basis of the property in the hands of the partnership. [IRC § 732(a)(1) and (2)]
- It is possible for a partner who receives property in liquidation of his partnership interest to obtain a basis in the property in excess of the partnership's basis in the property, except in the case of unrealized receivables and inventory.

The following example is premised on the fact that IRC §731 alone controls the tax consequences of the transactions described therein and the distributions occurred prior to August 5, 1997 (prior to 1/1/98 for California purposes)

Example 1:
On July 1, 1997, B has an adjusted basis in his partnership interest of $20,000. In complete liquidation of B's partnership interest, B receives $10,000 in cash, unrealized receivables with an adjusted basis of $10,000, inventory with an adjusted basis of $10,000, a piece of equipment with an adjusted basis of $5,000 and a truck with an adjusted basis of $10,000. B does not recognize a gain upon liquidation of his partnership interest since the cash distributed ($10,000) does not exceed B's basis in his partnership interest ($20,000). B will not recognize a loss since he received property other than cash, unrealized receivables and inventory. The following allocations are made:

Adjusted basis of partnership interest (7/1/97)	*$20,000*
Less: Cash distribution	*(10,000)*
Remaining basis to allocate	*10,000*

Allocation of basis to property:

	Partnership's Adjusted Basis	*Percentage*	*Allocation of Remaining Basis*
Unrealized	*$10,000*	*50*	*$5,000*
Receivables	*10 ,000*	*50*	*5,000*
Inventory	*$20,000*	*100*	*$10,000*
Equipment	*$0*		
Truck	*$0*		

6222 Distributions after August 5, 1997
Federal modified IRC §732(c) effective for distribution occurring after 8/5/97. California conformed to this change for tax years beginning on or after 1/1/98 and transactions occurring after 1/1/98. This means for distributions after 8/5/97,

federal provides that the basis be allocated as discussed below. For California purposes, the discussion below applies to distributions after 12/31/97.

The general rule applies to the distribution with basis being first applied to unrealized receivables and inventory items. Any remaining basis is allocated to other property. See PTM 6220.

The remaining basis is allocated to properties based on the unrealized appreciation or depreciation of the distributed properties. [IRC § 732(c)(1)]

Any increase in basis is allocated among the properties as follows:

- first, to properties with unrealized appreciation in proportion to the full extent of each property's unrealized appreciation, [IRC § 732 (c)(2)(A)] and
- to the extent of any remaining basis, it is allocated in proportion to the property's fair market value. [IRC § 732(c)(2)(B)]

A decrease in basis is required if the partner does not have sufficient basis to allocate the partnership's full basis in the properties.

Any basis decrease is allocated as follows:

- first, to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease, [IRC § 732(c)(3)(B)] and
- to the extent the required decrease is not allocated due to unrealized depreciation, in proportion to the respective bases of the properties. [IRC § 732(c)(3)(C)]

Example 1:
A partnership distributes both its assets A & B, in liquidation of a partner whose basis in its interest is $55. Neither asset consists of unrealized receivables or inventory. A has a basis to the partnership of $5 and a fair market value of $40, and B has a basis to the partnership of $10 and a fair market value of $10. Basis is first allocated $5 to A and $10 to B (their adjusted basis to the partnership). The remaining $40 is a basis increase (the partner's $55 basis minus the partnership's total basis in the distributed property of $15) which is first allocated to A in the amount of $35, its unrealized appreciation. Since B does not have any unrealized appreciation, no allocation is made. The remaining basis adjustment of $5 is allocated according to the assets fair market values, i.e. $4($40/50 x 5) to A (for a total basis of $44) and $1(10/50 x 5) to B (for a total basis of $11).
[H Rept No. 105-148 (PL 105-34) p. 505-506]

6230 Election to Make Adjustments

The election to adjust the basis of the partnership assets on a distribution of assets or a sale or transfer of a partnership interest is made **by the partnership**. The partnership must file a statement of election with the partnership return for the taxable year that the transfer of partnership interest or distribution of property occurs. [IRC § 754]

If there is a transfer of an interest due to an unforeseen event such as death, the election does not need to be made before the death occurred. It may be made when filing the partnership return for the year in which the death took place. [Rev Ruling 57-347, 1957-2 CB 365]

An election may be made after a transfer of a 50% or greater interest that results in a partnership technical termination. (See RIA ¶ 4300 for further details)

The election is made by a written statement that must be filed with the partnership return for the first year to which the election applies. In order for the election to be valid, the partnership return must be filed on time (including extensions). [Treas. Reg. § 1.754-1(b)]

The statement must:

- state the name and address of the partnership making the election,
- be signed by any one of the partners, and
- contain a declaration that the partnership elects to apply the provision of IRC §734(b) and IRC §743(b). [Treas. Reg. § 1.754-1(b)]

Once the election is made, it applies to all current and future distributions [Treas. Reg. § 1.754-1(a)] and transfers and can be revoked only with IRS permission. [Treas. Reg. § 1.754-1(c)]

Once an election is made, it may be revoked only with the consent of the District Director for the IRS District in which the partnership files its return. [Treas. Reg. § 1.754-1(c)]

- The regulations cite the following examples of reasons why a request for a revocation may be granted:
    1. a change in the nature of the partnership's business;
    2. a substantial increase in the assets of the partnership;
    3. a change in the character of the partnership's assets; or

4. an increased frequency of retirements or shifts of partnership interests causing an increased administrative burden on the partnership due to the IRC §754 election. [Treas. Reg. § 1.754-1(c)]

- The regulations specifically state "no application for revocation of an election shall be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution." [Treas. Reg. § 1.754-1(c)]

6240 Optional Basis Adjustments—IRC § 734

The general rule is that the adjusted basis of partnership property is not adjusted as a result of a distribution by the partnership to a partner. Under the general rule, a discrepancy may arise between the partnership's adjusted bases in their partnership assets and the partners' adjusted basis in their partnership interest. [IRC § 734(a); Treas. Reg. § 1.734-1(a)]

- This discrepancy may arise after a distribution in which the distributee partner recognizes gain or loss under IRC §731or in which the partner's adjusted basis in the distributed property is greater or less than the partnership's adjusted basis in the property prior to the distribution.

The general rule of IRC §734(a) often results in double inclusion of taxable income or double deduction of losses. (See Examples 1 and 2 below)

The §734(b) adjustment is designed to mitigate the discrepancies that would create a distortion in the amount and/or timing of income provided a §754 election is in effect. (See PTM 6230) If the election is valid, the partnership's bases in its assets are adjusted upon distribution by the partnership to the partner.

The §734(b) adjustment applies in the following instances:

- the distributee partner recognizes gain or loss under IRC §731 (See PTM 6120 and PTM 6200); [IRC § 734(b)(1)(A), § 734(b)(2)(A)]
- the distribute partner's adjusted basis in the distributed property is less than the partnership's adjusted basis in the property immediately before the distribution (See PTM 6140 and PTM 6220); [IRC § 734(b)(1)(B)] or
- the distributee partner's adjusted basis in the distributed property is greater than the partnership's adjusted basis in the property immediately before the distribution. [IRC § 734(b)(2)(B)]

The §734(b) adjustment affects all of the remaining partners.

The amount of the §734(b) adjustment is equal to the amount of gain recognized by the distributee partner. [IRC § 734(b)(1)(A), § 734(b)(2)(A)] Gain recognition by the distributee partner results in an increase to the partnership's basis in undistributed property in the amount of the gain recognized. [IRC § 734(b)(1)(A)] Alternately, if a distributee partner recognizes a loss on the distribution, the §734(b) adjustment to the partnership's basis in undistributed property is a negative adjustment equal to the distributee's recognized loss. [IRC § 734(b)(2)(A)]

Example 1:
On June 30, 1997, A has a 1/3 interest in partnership ABC, which has the following balance sheet:

ASSET	*BASIS*	*VALUE*
Cash	*$500,000*	*$ 500,000*
Land	*400,000*	*1,000,000*
	$900,000	*$1,500,000*

CAPITAL		
A	*$300,000*	*$ 500,000*
B	*300,000*	*500,000*
C	*300,000*	*500,000*
	$900,000	*$1,500,000*

On that date, ABC distributes the $500,000 in cash in liquidation of A's partnership interest. The land is a IRC § 1231 asset. Under IRC §731(a)(1), A is required to recognize $200,000 of taxable gain in connection with the distribution. This $200,000 represents A's 1/3 share of the $600,000 of appreciation in the land. If the partnership did not have an IRC §754 election in effect at the time of the distribution, the partnership's balance sheet would appear as follows:

ASSET	*BASIS*	*VALUE*
Cash	*$0*	*$0*
Land	*400,000*	*1,000,000*
	$400,000	*$1,000,000*

CAPITAL		
B	*$300,000*	*$500,000*
C	*300,000*	*500,000*
	$600,000	*$1,000,000*

As a result of the distribution, there is a discrepancy of $200,000 between the partnership's adjusted basis in the property and the partners' adjusted basis in his interest. If BC has a §754 election in effect, there is a $200,000 upward § 734(b) adjustment applied to the partnership's remaining assets. [IRC § 734(b)(1)(B)] The $200,000 is allocated using the rules set forth in IRC §755.

Without a § 754 election, if the land is subsequently sold by partnership BC for its $1,000,000 value, the full $600,000 gain inherent in the land must be recognized by the partnership. B and C will be subject to tax on $300,000 of gain each, even though $200,000 of the $600,000 gain has already been recognized by A.

Observation: *The "double taxation" described in example 1 above would be "made up" eventually even without the special basis adjustment because the gain recognized by the other 2 partners would increase their bases in their partnership interests. This basis increase would offset the earlier gain by giving the partners an equal reduction in gain (or a loss) when their partnership interests are disposed of. However, this "correction" of the double taxation might not occur for years and might not benefit the other two partners depending on their tax circumstances for the year of disposition.*

Example 2:
Assume Partnership ABC has the following balance sheet as of January 1, 1996:

Assets	*Adjusted Basis*	*Fair Market Value*
Cash	*$50,000*	*$50,000*
Capital Asset #1	*45,000*	*120,000*
Capital Asset #2	*55,000*	*70 ,000*
Total	*$150,000*	*$240,000*
Capital		
A	*$50,000*	*$80,000*
B	*$50,000*	*$80,000*
C	*$50,000*	*$80,000*
Total	*$150,000*	*$240,000*

The partnership distributes capital asset #2 to A, as a current distribution. A will not recognize any gain on the distribution since she did not receive any money in the distribution. A's adjusted basis in the distributed asset is limited to her adjusted basis in the partnership interest which is $50,000. If the partnership does not have an IRC § 754 election in effect, its balance sheet will appear as follows:

Assets	*Adjusted Basis*	*Fair Market Value*
Cash	*$50,000*	*$50,000*
Capital Asset #1	*45,000*	*120,000*
Total	*$95,000*	*$170,000*
Capital		
A	*$0*	*$10,000*
B	*$50,000*	*$80,000*
C	*$50,000*	*$80,000*
Total	*$100,000*	*$170,000*

The result of the distribution is a $5,000 discrepancy between the partnership's adjusted basis in its assets and the partners' adjusted basis in their partnership interests. If the partnership has a §754 election in effect, a §734(b) upward adjustment equal to the discrepancy is applied to increase the partnership's basis in its remaining assets. [IRC § 734(b)(1)(B)] The $5,000 adjustment is allocated to the remaining asset in the same class as the distributed asset. [IRC § 755] Therefore, the partnership's adjusted basis in capital asset #1 is increased by $5,000 to $50,000.

***Note:** The basis adjustment described above works both ways with respect to "double taxation." While it prevents the double taxation of gain as illustrated above, it also prevents a double tax benefit from losses that can occur. In Example 1 above, had A recognized a loss as a consequence of her liquidating distribution, and had the value of the partnership's land decline after the liquidation of her interest, absent a basis adjustment (here, a basis reduction), the partnership could incur an additional loss when it sells the land. Accordingly, a determination as to whether the partnership should file an election pursuant to IRC §754 basis adjustment must take into consideration the specific circumstances of the partnership.*

6250 Optional Basis Adjustments- IRC §743(b)

The general rule is that the adjusted bases of partnership assets are not adjusted upon a transfer of a partnership interest or upon the death of a partner. Therefore, the transferee partner's share of the adjusted basis of the partnership assets is the same as that of the transferor immediately before the transfer. [IRC § 743(a); Treas. Reg. § 1.743-1(a)]

- The transferee partner's adjusted basis in his partnership interest is generally equal to the cost of the partnership interest. [IRC § 742] The transferee partner's adjusted basis in his partnership interest may not equal the sum of his share of the partnership's adjusted basis in the assets. If this is the case, the discrepancy may distort the amount and timing of a new partner's share of income.

The §743(b) adjustment is designed to mitigate these distortions by allowing adjustments to a new partner's share of the partnership's adjusted bases in its assets.

If a basis adjustment election is in effect, upon a transfer of a partnership interest or the death of a partner, the transferee partner's basis in the partnership's property is:

- increased by any excess of the adjusted basis to the transferee partner of his partnership interest over his share of the adjusted basis of the partnership property, [IRC § 743(b)(1)] or
- decreased by any excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership. [IRC § 743(b)(2)]

A basis adjustment affects the basis of partnership property only with respect to the transferee partner and **not for the other partners**. This means that although the partnership makes the election and adjustment, the adjustment of the partnership's basis in its assets is only made with respect to the tax treatment of the transferee or successor partner. [IRC § 743(b)]

For purposes of depreciation, depletion, gain or loss, and distributions, the transferee partner will have a special basis for partnership assets that are adjusted under Code IRC §743(b). The transferee partner's special basis in each of the partnership's assets to which his special basis adjustment has been allocated is equal to his proportionate share of the common partnership basis for that asset (i.e., basis computed without regard to any special basis adjustments) plus or minus his special basis adjustments with respect to that asset. The Regulations require that the transferee partner's special basis adjustment be separated from his proportionate share of the basis in each of the partnership's assets. (See Treas. Reg. §1.743-1(b)(1))

Example:
R pays $50,000 for P's 40% interest in a partnership that has a basis in its assets of $60,000. Since a 40% interest in the basis of partnership assets is only $24,000, R has paid an excess of $26,000 over his share of the partnership's basis in its assets. If the partnership has an election in effect under IRC §754, R will be entitled to add a special basis adjustment of $26,000 to the basis of certain partnership properties (as determined under IRC §755) for purposes of calculating depreciation or gain or loss on the sale of those properties.

6300 CURRENT DISTRIBUTIONS

6310 Special Basis Property Distributed to Transferee

If a partnership distributes special basis property (property subject to a §743(b) adjustment) to the partner to whom the adjustment affects, the basis adjustment is taken into account in determining the partnership's adjusted basis in the property for purposes of calculating the distributee partner's basis in the property. [Treas. Reg. § 1.743-1(b)(2)(ii), §1.732-2(b)]

Example:
T & C are equal partners in partnership TC Tacos. The partnership owns several assets, one of which is a depreciable asset with a common partnership basis of $20,000 and a special basis adjustment to C of $5,000. If the partnership makes a current distribution of this asset to C, the partnership's adjusted basis in the asset with respect to C is $25,000. Therefore, assuming the § 732(a)(2) limitation does not apply, C's adjusted basis in the distributed asset is $25,000.

6320 Special Basis Property Distributed to Non-Transferee

If a partnership distributes special basis property (property subject to a §743(b) adjustment) to a partner to whom the §743(b) adjustment does not apply, the distributee partner does not take the adjustment into account for purposes of determining the partnership's adjusted basis in the property. [Treas. Reg. § 1.743-1(b)(2)(ii)]

The partner to whom the §743(b) adjustment applies, reallocates it in accordance with the rules in §755 to remaining partnership property of like kind or distributed property (if a distribution occurred). [Treas. Reg. § 1.743-1(b)(2)(ii)]

- Like property is defined as property of the same class; stock in trade, property used in the trade or business, or capital assets. [Treas. Reg. § 1.743-1(b)(2)(ii)]

Example:
L and M are equal partners in L M Partnership. The partnership owns several assets, two of which are depreciable assets. Depreciable asset #1 has a

common basis to the partnership of $8,000 and a special basis adjustment to M of $2,000. Depreciable asset #2 has a common basis of $10,000 and a special basis adjustment to M of $3,000. The partnership makes a current distribution of asset #1 to L and asset #2 to M. The partnership's adjusted basis in asset #1 with respect to L is $8,000. Therefore, assuming the limitation of IRC §732(a)(2) does not apply, L's basis in the distributed property is $8,000. The partnership's adjusted basis in asset #2 with respect to M is $15,000 (10,000 common basis plus $3,000 basis adjustment allocated to asset # 2 plus $2,000 basis adjustment originally allocated to asset #1 and reallocated to asset #2). Assuming the limitation of IRC §732(a)(2) does not apply, M's adjusted basis in asset #2 is $15,000. [Treas. Reg. § 1.743-1(b)(2)(ii) Example 1]

If M had not received a distribution of property, the $2,000 basis adjustment originally allocated to asset #1 would still have been reallocated to asset #2 (assuming it was the partnership's sole asset).

6330 Liquidating Distribution to a Transferee Partner

If a transferee partner receives a distribution in liquidation of his entire partnership interest, the partner is considered to have relinquished his interest in any remaining partnership property. [Treas. Reg. § 1.743-1(b)(2)(ii)]

If a transferee partner relinquishes his interest in other property of a like kind with respect to which they have a special basis adjustment (property subject to a §743(b) adjustment), the partnership's adjusted basis in the distributed property with respect to the transferee/distributee partner includes the special basis adjustment for the property in which the partners have relinquished their interest. [Treas. Reg. § 1.743-1(b)(2)(ii)]

This reallocation does not increase the partner's aggregate basis in the distributed property because in a liquidating distribution, the distributee partner's basis in the distributed property is equal to the partner's adjusted basis in his partnership interest (less any money received in the distribution). Nevertheless, the reallocation may affect how the basis will be allocated among the distributed properties under IRC §732(c). See Treas. Reg. §1.743-1(b)(2)(ii)Example (2)(b)

6400 DISTRIBUTION OF MARKETABLE SECURITIES

6410 General

- For Federal purposes, IRC §731(c) generally applies to distributions after December 8, 1994, the date of its enactment. **California does not conform to this Code Section until 1/1/97, applicable for distributions occurring on or after 1/1/97.**

- IRC §731(c) was enacted due to a concern that under the prior law, a partner was able to exchange, tax free, his share of appreciated partnership assets for an increased share of the partnership's marketable securities without gain recognition. [H. R. No. 826, 103d Congress, 2^{nd} Session 187]

- For purposes of gain recognition, when a partner receives a distribution of money in excess of his basis, a distribution of marketable securities is treated as a distribution of money. [IRC § 731(c)(1)(A)]

- The marketable securities are treated as money in an amount equal to their fair market value as of the date of distribution. [IRC § 731(c)(1)(B)]

- Where a deemed partnership termination occurs as a result of a transfer of a 50% or greater partnership interest, the termination does not cause the partners to recognize gain as a result of a deemed distribution of the partnership's marketable securities. [Treas. Reg. § 1.731-2(g)(2)]

- Generally, the distributee partner will recognize gain to the extent he receives a distribution of marketable securities whose fair market value exceeds the basis of his partnership interest immediately before the distribution. [H. R. No. 826, 103d Congress, 2nd Session 189] In computing the amount of gain that the distributee partner must recognize, it should be noted that the amount of his gain will be computed by aggregating the amount of other money distributed to him in the same transaction along with the fair market value of the marketable securities.

Example:
Nancy and Rich form N & R Partners as equal partners. Nancy contributes property with a fair market value of $2,000 and an adjusted basis of $500 to the partnership and Rich contributes $2,000 of cash. The partnership subsequently purchases Stock in X Co, a marketable security within the meaning of IRC § 731(c) (See PTM 6420*) for $1,000 and immediately distributes the stock to Nancy in a current distribution. The basis of Nancy's interest at the time of distribution is $500 (the adjusted basis of the property contributed). The distribution of Stock X is treated as a distribution of money in an amount equal to the fair market value of Security X on the date of distribution ($1,000). The amount of the distribution that is treated as money is not reduced under IRC §731(c)(3)(B) because if Stock X had been sold immediately before the distribution, there would have been no gain recognized by N & R and Nancy's distributive share of gain would be $0. As a result, Nancy recognizes $500 of gain under §731(a)(1) on the distribution ($1,000 distribution of money less $500 adjusted basis in Nancy's partnership interest).*

Note: Although this transaction does not trigger any adverse effects under IRC §731(c), the facts should be further analyzed to determine if other provisions of the Code may cause taxable consequences, e.g. 707(a)(2)(B), 704(c)(1)(B), 737 and 751(b).

6420 Definition of Marketable Securities

Marketable securities is defined as financial instruments and foreign currencies which are actively treaded on the date of distribution. [IRC § 731(c)(2)(A)]

Marketable Securities include [IRC § 731(c)(2)(C)]:
- Stocks and other equity interests;
- options;
- evidences of indebtedness;
- forward or futures contracts;
- notional principal contracts;
- derivatives;

- an interest in a common trust fund, [IRC § 731(c)(2)(B)(i)(I)] or in a regulated investment company; [IRC § 731(c)(2)(B)(i)(II)]
- any interest readily convertible into or exchanged for money or marketable securities, pursuant to its terms or any other arrangements; [IRC § 731(c)(2)(B)(ii)]
- any financial instrument whose value is determined substantially by reference to marketable securities; [IRC § 731(c)(2)(B)(iii)]
- any interest in precious metal which is actively traded, unless the metal was produced, used or held in the active conduct of a trade or business by the partnership; [IRC § 731(c)(2)(B)(iv)]
- any interest in an entity if substantially all of the assets (90% or more) of that entity consist directly or indirectly, of marketable securities, money or both; [IRC § 731(c)(2)(B)(v)]
- any interest in any entity to the extent that the value of the interest is attributable to marketable securities, money or both if more than 20%, but less than 90%, of the entity's assets (measured by value) consist of marketable securities and money. [IRC § 731(c)(2)(B)(vi)]

Commodities (other than precious metals) are not considered marketable securities. [H. R. No. 826, 103d Congress, 2nd Session 189]

Actively traded options, futures and forward contracts are treated as marketable securities, whether or not they relate to commodities.

6430 Limitation on Gain Recognized

The amount of marketable securities taken into account is reduced (but not below zero) by the excess (if any) of:

1. the partner's distributive share of net gain that would be recognized if all marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value,
   [IRC § 731(c)(3)(B)(i)]

   over

2. the partner's distributive share of net gain that is attributable to the marketable securities of the same class and issue as the distributed securities held by the partnership immediately after the transaction, determined using the fair market value. [IRC § 731(c)(3)(B)(ii)]

A partner's distributive share of net gain is determined:

- by taking into account any basis adjustments under IRC §743(b) with respect to that partner, i.e., adjustments resulting from a sale or exchange or a death of a partner, [Treas. Reg. § 1.731-2(b)(3)(i)]
- without taking into account any special allocation if the principal purpose of the allocation was to avoid or minimize the effect of IRC §731(c), [Treas. Reg. § 1.731-2(b)(3)(ii)] and
- without taking into account any gain or loss attributable to a distribution of a security if one of the following exceptions apply:
  1. The security was contributed to the partnership by the recipient partner;
  2. The security was acquired by the partnership in a nonrecognition transaction, subject to certain other conditions prescribed by the Regulations, or
  3. The security was not a marketable security on the date it was acquired by the partnership, subject to certain other conditions prescribed by the Regulations. [Treas. Reg. § 1.731-2(b)(3)(iii)]

Example 1:
Partnership ABC holds 300 shares of X Corporation common stock (a marketable security) and other assets. A owns a 1/3 interest in ABC. The stock has a basis of $10 ***a share*** *and a value of $100* ***a share****. A has a $5,000 basis in his partnership interest. ABC distributes all of the stock in X to A in liquidation of his partnership interest. Under the rule treating marketable securities as a cash distribution, A is treated as receiving $30,00 in cash (300 shares x $100 per share). Under the above rule, the amount is reduced by $9,000, the amount that A would have to recognize if the partnership had sold the securities (($30,000 fair market value less $3,000 adjusted basis) divided by his 1/3 interest which equals $9,000). Therefore, A is treated as receiving a cash distribution of $21,000 ($30,000 less $9,000). The end result is that A would recognize a gain of $16,000 on this transaction ($21,000 distribution less $5,000 adjusted basis in partnership interest. [H. R. 826, 103d Congress, 2nd Session 192]*
Note: This example is used to show the effect of IRC § 731(c). However, the facts should be further analyzed to determine if other provisions of the Code may cause taxable consequences, e.g. 707(a)(2)(B), 704(c)(1)(B), 737, 736 and 751(b).

Example 2:
J is a 50% partner in a partnership. The partnership distributes Security X to J in a current distribution. Immediately before the distribution, the partnership held

securities with the following adjusted bases, fair market values and unrecognized gains or losses:

	Value	*Basis*	*Gain/Loss*
Security X	*$100*	*$70*	*$30*
Security Y	*$100*	*$80*	*$20*
Security Z	*$100*	*$110*	*($10)*

If the partnership had sold the securities for their fair market value immediately before the distribution to J, the partnership would have recognized $40 of net gain ($30 gain on Security X plus $20 gain on Security Y less $10 loss on Security Z). J's gain would be $20 (one half of $40 net gain). If the partnership distributes Security X to J and sells the remaining securities immediately after the distribution, the partnership would have $10 of net gain ($20 of gain on Security Y less $10 loss on Security Z). J's distributive share of this gain would have been $5 (one half of $10 net gain). As a result, the distribution resulted in a decrease of $15 in J's distributive share of the net gain in the partnership's securities ($20 net gain before the distribution less $5 net gain after distribution). The amount of the distribution of Security X that is treated as a cash distribution is reduced by $15, with the result that the distribution of Security X is treated as an $85 cash distribution to J ($100 fair market value of Security X less $15 reduction). [Treas. Reg. § 1.731-2(j), Example 2]

Note: For more examples, see Treas. Reg. §1.731-2(j)

6440 Exceptions to Gain Recognition Rules

There are several exceptions to the general rule that gain is recognized upon a partnership distribution of marketable securities. The exceptions include:

- Marketable securities contributed by distributee partner, (See PTM 6441)
- Securities not marketable when acquired by partnership, (See PTM 6442)
- Securities acquired in a nonrecognition transaction. (See PTM 6443)

6441 Marketable Securities Distributed to Contributor

A partner does not recognize gain if a distribution is made to him of marketable securities that he contributed to the partnership.

Under IRC §731(c)(3)(A)(i), a marketable security is not treated as money if it was contributed by the partner to whom it is distributed. [Treas. Reg. § 1.731-2(d)(1)]

6442 Securities not Marketable when Acquired by Partnership

The distribution of marketable securities is not treated as a distribution of money if:

- The security was not a marketable security on the date acquired by the partnership and the entity that issued the marketable security had no outstanding marketable securities on that date;
- The security was held by the partnership for at least six months before the date the security became marketable; and
- The partnership distributed the security within five years from the date the security became marketable.

[IRC § 731(c)(3)(A)(ii) and Treas. Reg. § 1.731-2(d)(3)]

6443 Securities Acquired in a Nonrecognition Transaction

A distribution of a marketable security is not treated as a distribution of money to the extent that:

- The security was acquired by the partnership in a nonrecognition transaction in exchange for property other than marketable securities or cash;
- The value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction is less than 20% of the value of all the assets exchanged by the partnership in the nonrecognition transaction; and
- The partnership distributes the security five years from the later of
    1) the date the security was acquired by the partnership, or
    2) the date the security became marketable.[Treas. Reg. § 1.731-2(d)(1)(ii)]

6450 Distributions by Investment Partnerships

Marketable securities will not be treated as money for the purpose of IRC §§ 731(a)(1) and 737 if the partnership making the distribution is an "investment partnership" and the partner that receives the distribution of marketable securities is an eligible member of the partnership. [IRC § 731(c)(3)(A)(iii)]

- An eligible partner is defined as any partner, who before the date of the distribution, did not contribute any property to the partnership other than assets described below. [IRC § 731(c)(3)(C)(iii)(I)]

An investment partnership is defined as any partnership that has never engaged in a trade or business and substantially all of its assets (by value) have consisted of the following:

- cash, [IRC § 731(c)(3)(C)(i)(I)]
- stock in a corporation, [IRC § 731(c)(3)(C)(i)(II)]
- notes, bonds, debentures or other evidence of indebtedness, [IRC § 731(c)(3)(C)(i)(III)]
- interest rate, currency or equity notional principal contracts, [IRC § 731(c)(3)(C)(i)(IV)]
- foreign currencies, [IRC § 731(c)(3)(C)(i)(V)]
- interests in or derivative financial instruments (options, forwards, future contracts, shorts positions) relating to any asset described above. [IRC § 731(c)(3)(C)(i)(VI)]

For a further discussion of investment partnerships, see PTM 4550.

6460 Basis of Marketable Securities Distributed

If a distributee partner recognizes gain because marketable securities distributed to the partner are treated as cash, the basis of the marketable securities is their basis determined under the normal distribution rules (See PTM 6140 for current distributions or PTM 6220 for liquidating distributions) increased by the gain recognized by the partner. [IRC § 731(c)(4)(A)(ii)]

Note: The following examples assume that the partnership does not have any other securities or that IRC §731(c)(3)(B) does not come into play.

Example 1:
N is a partner in partnership NB and her interest in the partnership is $100. Partnership NB distributes Security X, with a basis of $90 and a fair market value of $105 to N. Under the rules described above, the distribution of Security X is treated as a $105 cash distribution. The result is that N must recognize $5 of gain on the distribution. N's adjusted basis in Security X is $95 ($90 adjusted basis of Security X plus $5 of gain recognized by N). [Treas. Reg. § 1.731-2(j), Example 5]

Example 2:

N is a partner in NB and has a $10 basis in her partnership interest. NB distributes to N in a ***current distribution*** *1) Security X with a fair market value and adjusted basis of $40 and 2) Property Z with an adjusted basis and fair market value of $40. Under the rules described above, the distribution is treated as a $40 cash distribution, with the result that N recognizes $30 of gain on the distribution. N's adjusted basis in Security X is $35 ($5 adjusted basis under rules described in* PTM 6140 *plus $30 of gain recognized). N's adjusted basis in Property Z is $5 under the rules described in* PTM 6140*. [Treas. Reg. § 1.731-2(j), Example 6]*

The increase in basis is allocated to the distributed marketable securities in proportion to their respective amounts of unrealized appreciation before the basis increase. [IRC § 731(c)(4)(b)]

6500 DISTRIBUTION OF INVENTORY AND ACCOUNTS RECEIVABLE

6510 Distribution of Inventory and Accounts Receivable-(§751)

If a partnership distributes unrealized receivables or substantially appreciated inventory, the gain associated with the disposition may be treated as ordinary income or loss. [IRC § 735(a)]

Certain distributions of unrealized receivables or substantially appreciated partnership inventory (§751 property) will result in gain recognition to the partner, partnership or both. Not all distributions of §751 property result in recognition of gain (loss is never recognized), only **uneven distributions** (non-prorata distributions).

Gain recognition can result to the extent that the distribution is re-characterized as a sale of a portion of the partner's share of §751 property. [IRC § 751(b)(1)] In order for this rules to apply:

- the partner must receive more than his share of unrealized receivables or substantially appreciated inventory items in a partnership distribution in exchange for less than his share of partnership's other assets, i.e., assets other than unrealized receivables or substantially appreciated inventory (non §751 property); or

- the partner must receive less than his share of unrealized receivables or substantially appreciated inventory items in a partnership distribution in exchange for more than his share of the partnership's non- §751 property.

It is not necessary that a partner receive a prorata portion of each item of §751 property of the partnership in order for the distribution to be proportionate. The partner must receive §751 property with a value equal to that partner's interest in the total value of §751 property owned by the partnership in order for the non-recognition rules to apply. In addition, the partner receiving the distribution of §751 property must not surrender any portion of his interest in the non-§751 property of the partnership as a consequence of the distribution.

Gain from the distribution of §751 property may result from both current and liquidating distributions.

If the distribution is a liquidating distribution, it must be determined whether all or a portion of the distribution is a payment received for partnership property. (See PTM 6600) If the payments are not received for partnership property, they are considered §736(a) payments and are accepted from these recognition provisions of IRC §751(b). [IRC § 751(b)(2)(B)]]

For further information regarding disproportionate distributions, see McKee, Nelson & Whitmire: *Federal Taxation of Partnerships and Partners,* Third Edition ¶ 21.04

6520 Effects of a Distribution of Inventory and Receivables

To the extent that a partner receives §751 property in a distribution that is in exchange for part of his interest in non-§751 property, the transaction will be treated as a sale or exchange of property between the distributee partner and the partnership. [Treas. Reg. § 1.751-1(b)(2)(i)] The portion of the distribution that is not treated as a "sale or exchange" will be governed by the general rules relating to distributions, i.e., §§731 through 736.

Ordinary income or loss is recognized by the partnership to the extent of the difference between the fair market value and the partnership's adjusted basis of the receivables and inventory that the partnership is deemed to have sold as a consequence of the distribution. The income or loss is allocated to the nondistributee partners and is shown separately on the partnership return. [Treas. Reg. § 1.751-1(b)(2)(ii)]

The partnership's basis in the non-§751 property that it is deemed to have purchased from the distributee partner is equal to its fair market value i.e., its cost as determined under IRC §1012.

Gain or loss is also recognized by the distributee partner to the extent of the difference between the adjusted basis of the non-§751 property that he gave up and the fair market value of the §751 property that he was deemed to have received in the fictional exchange. [Treas. Reg. § 1.751-1(b)(2)(iii)]

- The partner's basis in the non-§751 property relinquished is the basis the property would have had if the distributee partner had received that property in a current distribution immediately before the actual distribution which is treated as a sale or exchange.
- The gain or loss is either capital or ordinary depending on the character of the property given up.

The distributee partner's basis in the §751 property that he is deemed to have purchased from the partnership is equal to its fair market value, i.e., its cost as determined under IRC §1012, while his basis in the §751 property that he is deemed to have received as a distribution from the partnership is determined under the rules applicable to distributions. [Treas. Reg. § 1.732-1(e)]

Example:
A partnership's §751 property has a value of $200,000. A 30% partner's interest in the §751 property is $60,000. If he receives $40,000 of this type of property and continues to have a 30% interest in the remaining §751 property, he is considered to have received $12,000 as his share of these assets i.e., $60,000 less $48,000 (30% of $160,000 remaining §751 property). The remaining $28,000 represents a distribution in excess of his share of §751 property .
[Treas. Reg. § 1.751-1(b)(1)(ii)]

6525 Effects of a Distribution of Other Property

To the extent a partner receives more than his share of non-§751property (including money) in return for his interest in §751 property, the partnership is considered to have sold the excess non-§751 property to the recipient partner for an amount equal to the fair market value of the excess §751 property retained by the partnership. [Treas. Reg. § 1.751-1(b)(3)(i)]

The partnership's gain or loss is equal to the difference between the fair market value of the non-§751 property and its adjusted basis in the hands of the partnership. [Treas. Reg. § 1.751-1(b)(3)(ii)]

- The gain is either capital or ordinary depending on the character of the property sold.
- The gain or loss is allocated to the nondistributee partners and is shown separately on the tax return. [Treas. Reg. § 1.751-1(b)(3)(ii)]

The partnership's basis in the unrealized receivables and substantially appreciated inventory that it is deemed to have acquired from the distributee partner is equal to the fair market value of the other property at the time of the deemed "sale or exchange".

The distributee partner recognizes ordinary income or loss to the extent of the difference between the fair market value non-§751 property that he received, and the adjusted basis of the IRC §751 property that he relinquished, in the fictional sale or exchange. [Treas. Reg. § 1.751-1(b)(3)(iii)]

- The partners adjusted basis in the §751 property that he is deemed to have sold in the fictional sale or exchange is the basis the assets would have had if the property had been received by the distributee partner in a current distribution immediately before the actual distribution. [Treas. Reg. § 1.751-1(b)(3)(iii)]

The distributee partner's basis in the non-§751 property that he is deemed to have purchased from the partnership is equal to its fair market value, i.e., its cost as determined under IRC §1012, while his basis in the non-§751 property that he is deemed to have received as a distribution from the partnership is determined under the rules applicable to distributions i.e., §§731 through 736. [Treas. Reg. § 1.732-1(e)]

6530 Definition of Inventory

Inventory must be "substantially appreciated" in order to be considered §751 property.

- For Federal purposes after April 30, 1993 and California purposes after 1/1/97, inventory is considered substantially appreciated if its fair market value exceeds 120% of its adjusted basis. [IRC § 751(d)(2) as amended by Revenue Reconciliation Act 1993]

- For California purposes (prior to 1/1/97), inventory is considered substantially appreciated if :
  1. the fair market value of the property exceeds 120% of its adjusted basis, and
  2. the fair market value of the property exceeds 10% of the fair market value of all partnership property other than money.

"Inventory" includes stock in trade and property held primarily for sale to customers (as defined in IRC §1221(1)). [IRC § 751(d)(1)]

- Inventory also includes any partnership property other than capital assets or IRC §1231 property, as well as foreign investment company stock.

- In determining whether property meets these definitions of inventory, the property is evaluated from both the partnership's and the distributee partner's point of view. [IRC §§ 751(d)(2)and 751(d)(3)] For example, if property would be classified as inventory in the hands of the distributee partner, it will be deemed to be inventory in the hands of the partnership for purposes of IRC §751(b) purposes.

An item of inventory property is excluded from the calculation of the 120% test if a principal purpose for acquiring it was to avoid having the partnership's inventory treated as substantially appreciated inventory. [IRC § 751(b)(3)(B)]

Example:
ABC Partnership has the following balance sheet:

	Adjusted Basis	*Fair Market Value*
Assets:		
Cash	*$300*	*$300*
Inventory:		
X	*0*	*100*
Y	*0*	*100*
Z	*150*	*100*
Total assets	*$450*	*$600*
Capital:		
A	*$150*	*$200*
B	*150*	*200*
C	*150*	*200*
Total capital	*$450*	*$600*

*All of ABC's inventory items are **"substantially appreciated"** under § 751(d)(1), since their aggregate fair market value ($300) exceeds 120% of their aggregate basis (Basis $150 x 120% = $180).* [IRC § 751(b)(3)]

*A's share of the **value** of partnership §751 property is $100 (1/3 of $300 fair market value), and A's share of the **unrealized ordinary income** inherent in the §751 property is $50 (1/3 of the excess of $300 fair market value of the inventory less the $150 adjusted basis of the inventory). If partner A withdraws from the partnership and receives a cash distribution of $100 plus any one of the inventory items, the distribution does not trigger §751(b), since A receives §751 property with a market value ($100) equal to his predistribution share of partnership §751 property. However, any such distribution will distort the amount of ordinary income realized by A. For example, if A receives a distribution of either inventory item X or Y (both of which have $0 basis), his basis in the item will be zero* [IRC § 732(c)(1)]*, and he will realize ordinary income of $100 if he then sells the inventory item for its fair market value.* [IRC § 735(a)(2)] *The BC partnership will have only $50 of gain inherent in the remaining inventory items after the distribution; if they are both sold B and C will each have $25 of ordinary income. Therefore, after A withdraws from the partnership and receives the distributions described above, the $150 of ordinary income inherent in partnership inventory prior to the distribution would thus be subsequently realized (i.e., when sold) in the amounts of $100 by A and $25 each by B and C.*

6540 Definition of Unrealized Receivables

Rights to payment for goods or services that the partner has not yet included in income are categorized as unrealized receivables.

- An unrealized receivable can also be one of many other assets that are capable of producing ordinary income to a partnership.
- Any of the following items will be categorized as an unrealized receivable:
    - mining property,
    - §1245 property,
    - stock in a DISC or certain other foreign corporation (not applicable for California purposes),
    - §1250 property,
    - farm land,
    - franchises, trademarks or trade names,
    - certain oil and gas property (not applicable for California purposes),
    - market discount bonds, and short-term obligations.

The distinguishing feature of all of these items is that they are capable of producing ordinary income. [IRC § 751(c)]

6550 Exceptions to the General Rule of §751

The general rule of §751(b) does not apply to the distribution of property to a partner who contributed the property. This type of transaction is governed by the general distribution rules covered under §731- § 736. [Treas. Reg. § 1.751-1(b)(4)(i)]

Payments made to a retiring partner or a deceased partner's successor in interest are not subjected to IRC §751(b) if such payments are considered a distributive share of partnership income or guaranteed payments (§736(a) payments). [Treas. Reg. § 1.751-1(b)(4)(ii)] (See PTM 6600)

- Payments which are considered as made in exchange for an interest in partnership property (§736 (b) payments) are subject to §751(b) if the distribution involves an exchange of substantially appreciated inventory. [Treas. Reg. § 1.751-1(b)(4)(ii)]

6560 Distribution of Partner Debt

A partner can become indebted to a partnership in several ways. If a partnership distributes a partner's debt to the debtor, the tax consequences vary. Some of the types of debt that can be canceled in this manner are:

- A direct loan from a partnership to a partner (See PTM 6561)
- Partner debt purchased by a partnership from a third party (See PTM 6562)
- Debt of a partner contributed to a partnership as part of a partner's capital contribution (See PTM 6563)
- Debt from a transfer of property to a partner from a partnership in exchange for deferred payments (See PTM 6564)

6561 Direct Loan

- If a partnership loans money to a partner and the loan is subsequently cancelled, the partner whose debt was cancelled will be deemed to have received a distribution of money or property at the time of cancellation." [Treas. Reg. § 1.731-1(c)(2)]

- The partnership will not recognize any gain or loss under IRC §731(b) when it distributes money or property to a partner(s). A partner who receives a distribution from a partnership will not recognize gain or loss under IRC §731(a)(1) unless the amount of money (including debt relief) received in the distribution exceeds the basis of his partnership interest.

- The regulations do not specify the amount of the deemed distribution of money when a partner's debt is canceled by a partnership. Commentators have said that the amount should be equal to the fair market value of the debt at the time it is cancelled, rather than its face amount. [See McKee, Nelson & Whitmire: Federal Taxation of Partnerships and Partners, Third Edition ¶ 19.02[5][a].]

- If the distributee partner recognizes a gain or loss and the partnership has a §754 election in effect, the basis of the partnership assets may be increased or decreased in accordance with IRC §734(b).

6562 Partner Debt Acquired from Third Parties

Revenue Ruling 93-7, provides that a distribution of a partner's debt that has been acquired by a partnership from a third party is considered a property distribution. [Revenue Ruling 93-7, 1993-1 CB 125]

Since it is a property distribution, no gain or loss is recognized by the partnership. [IRC § 731]

The ruling divides the transaction as to the debtor-partner into two parts:

- First, the debt is considered property, and not money. The partnership is deemed to distribute the debt to the debtor partner, who acquires a basis in the distributed debt pursuant to the rules of IRC §732.
- Second, after the debtor-partner receives the distributed debt, the Ruling views the debt as being cancelled for an amount equal to its fair market value (FMV). Under the Ruling, the debtor-partner realizes cancellation of indebtedness income measured by the difference between the FMV of the distributed debt and its basis as determined under step one above. [IRC § 61(a)(12)]

6563 Partner Debt Contributed in Exchange for Partnership Interest

In many instances, a partner will contribute a promissory note and money in exchange for a partnership interest. This type of note does not increase a partner's interest in his partnership interest unless payments are made to the partnership. (See PTM 5460)

When a partnership distributes this type of note to a partner, it is considered a non-event for tax purposes unless it causes a reduction in the partner's share of partnership liabilities that may cause a deemed cash distribution in accordance with IRC §752(b).

6564 Transfer of Property in Exchange for Deferred Payments

If a partner enters into a deferred payment obligation to pay a partnership for property purchased from the partnership and the obligation is cancelled, the obligor partner will be considered to have received a distribution of money. [S. Report No-1622, 93d Congress, 2nd Session. 30 (1954)]

Regulation §1.731-1(c)(2) that treats the cancellation as being tantamount to the distribution of money controls this type of transaction.

6570 Distribution to Corporate Partner of its Own Stock

Nonrecognition of gain or loss under IRC §731(a) is not available when a corporate partner receives a partnership distribution of its own stock. [Notice 89-37, 1989-1 CB 679]

A distribution to a corporate partner of its own stock (or stock of an affiliate) is treated as a redemption of the partner’s stock in exchange for all or a portion of the partner’s partnership interest.

The IRS disregards the partnership and treats the corporation as if **redeemed** its stock directly from the other partners in exchange for property equal in value to the redeemed stock.

The IRS treats the corporation as if it exchanged its interest in the partnership for the stock. The value of the partnership interest reflects the value of property that the corporation has contributed to the partnership.

The transaction is taxed as a corporate distribution of appreciated property to the other partners. [IRC § 311(b)] The corporation recognizes gain equal to the difference between the partner’s basis in the portion of the partnership interest considered transferred and the fair market value of that interest (equal to the value of the stock distributed).

The special rule for distributions of a corporation's own stock is designed to close a loophole that had been used by corporations to achieve tax-free redemptions of stock for property, in violation of the spirit of IRC §311(b).

There is a de minimis provision that would exempt corporations from the distribution rule if the corporation has only a small investment in the partnership. [Proposed Treas. Reg. §1.337(d)-3(f)]

- A distribution would be exempt if the corporate partner owns not more than five percent of the partnership and the amount of the partner's stock held by the partnership is not more than $250,000, or two percent of the value of any class of stock issued by the partner, whichever is less.

- Additionally, an exemption for inadvertent transfers would provide an exemption if the partnership disposes of the stock in the same year it was acquired, and the stock was never distributed to the corporate partner or affiliate.

Example:
Able Corp, a C corporation, and A, an individual, form A & A Partnership. Able Corp contributes appreciated assets to A & A having a basis of $0 and a fair market value of $100. A, a shareholder in Able Corp, contributes Able Corp stock to A & A Partnership. A's stock has a basis of $50 and a fair market value of $100. Under IRC §721(a), the contributions of property and stock to the partnership are not taxable events to partners Able Corp and A. A & A then distributes the Able Corp stock, contributed by A, to Able Corp. The appreciated property is distributed to A. Under IRC §731(a), without special rules, the distribution of stock and appreciated property would not be taxable to the recipient partners. The tax consequences under IRC §311(b), following the 1986 repeal of General Utilities are not tax-free. Able Corp is treated as having sold its property and recognizes a gain of $100; A is treated as having sold his stock for $100, the value of the property received, and recognizes gain of $50. Notice 89-37 assigns the same results for the corporation with or without the partnership as middleman.

Note: The transaction described in the above example may also be subject to other provisions of the Code, e.g., 707(a)(2)(B), 704(c)(1)(B), 737, 736 and 751(b).

6575 Deemed Redemptions of Corporate Partner's Stock

In addition to actual distributions of a corporate partner's own stock, "indirect" distributions of a corporate partner's own stock will also be taxed as a sale or exchange.

- An indirect distribution is a transaction in which no distribution occurs and the corporation never regains possession of the stock, but which produces the same economic result as if the corporation traded appreciated property for its own stock. [Notice 89-37, 1989-1 CB 679]

- A deemed redemption is not an actual distribution of stock, but it is deemed to have the economic effect of a surrender by the partner of a portion of its interest in the partnership (i.e., a share in the appreciated property owned by the partnership).

The deemed redemption rule applies to any transaction or series of transactions, which has the economic effect of an exchange of appreciated property for the partner's stock (i.e., a stock redemption).

Circumstances which might cause this economic effect include when a corporate partner contributes property to a partnership which owns stock in the partner; or when a partnership acquires stock of a partner; or when a partnership makes disproportionate distributions to partners having the same economic effect as a stock redemption; or when a partnership agreement is amended to provide different sharing ratios of partnership items. [Prop. Treas. Reg. §1.337(d)-3(d)(1)]

Example:
Able Corp, a corporation, and A, an individual who is also a shareholder of Able Corp, form equal partnership A & A. Able Corp contributes appreciated property to A & A. The basis of the property is $0, and the fair market value of the contributed property is $100 at the time of contribution. A contributes Able Corp stock to partnership A & A with a basis and fair market value of $100. Under the deemed redemption rule, at the time the appreciated property is contributed to A & A, Able Corp is considered to have relinquished 50% of its interest in the appreciated property in exchange for 50% of the partnership's Able Corp stock. The property deemed exchanged has a basis of $0 and a fair market value of $50 (representing A's 50% interest in the partnership). Able Corp will recognize $50 gain as a result of the transaction and will increase its basis in CA by $50.
[Prop. Treas. Reg. §1.337(d)-3(h), Example 1]

6580 Distributions of Property Subject to Liabilities

A distribution of property subject to a liability is treated as two separate transactions:

- first, a transaction in which the partner assumes a partnership liability, plus
- second, a distribution of partnership property.

A distribution of encumbered property can result in gain to the partner receiving the distribution, or to any other partner whose share of partnership liabilities is reduced as a result of the distribution, if the net reduction in the partner's liabilities as a result of the transaction exceeds the partner's basis in the partnership immediately before the distribution. [IRC § 731(a), IRC § 752(b)]

A partner's assumption of a partnership liability is treated as a constructive contribution of money to the partnership. [IRC § 752(a)]

A decrease in a partner's share of partnership liabilities is treated as a distribution of money to the partner from the partnership. [IRC § 752(b)]

When partnership property subject to a liability is distributed to a partner, the transferee partner is treated as having assumed the liability. [Treas. Reg. §1.752-1(e)]

- This would decrease the remaining partners' shares of the liability to the extent that they had been liable for it prior to the distribution. The amount of the decrease is treated as a money distribution.

When encumbered property is distributed, the decrease in liabilities is treated as a constructive distribution of cash, and will reduce a partner's basis in the same manner as an actual cash distribution. [IRC § 752(b)}

- Any partner who included a share of the liability in the basis of his partnership interest, including the partner receiving the distribution of the encumbered property, will be treated as receiving a constructive distribution of money when the property is distributed. [IRC § 752(b)]

Increases and decreases in a partner's share of partnership liabilities can both occur when property subject to a liability is distributed. When this happens, the increases and decreases in liabilities are netted in order to determine whether a partner will be treated, overall, as having made a contribution or as having received a distribution as a result of the transaction. [Treas. Reg. §1.752-1(f)]

If more than one encumbered property is distributed as part of a single transaction, the increases and decreases in liabilities resulting from all of the distributions will be offset in determining the overall result for the partners. [Rev. Ruling 79-205]

If the constructive cash distribution exceeds the partner's basis in his partnership interest, the partner will recognize gain in the same manner as a partner receiving an actual cash distribution. [IRC § 731(a)(1)]

Adjustments to a partner's basis caused by an increase or decrease in the partner's share of partnership liabilities are made before the property distribution is taken into account. [IRC §§ 732(a)(2) and 732(b)]

- If the partner's net decrease in liabilities exceeds his basis in the partnership immediately before the property was distributed, the partner will recognize gain in the amount of the excess; and the partner's basis in the distributed property in that event will be the basis in his partnership interest, rather than the partnership's basis in the property—i.e., zero.

Example 1:
G and T are equal partners in GTA. G has a basis of $1,000 in his partnership interest. GTA distributes property to G (other than § 751 property). The property has a basis to GTA of $2,000, and is subject to a liability of $1,600. As a result of the distribution, G's basis in his partnership interest is increased by $1,600 to reflect his assumption of the liability. At the same time, his basis is also decreased by $800 to reflect the reduction in G's share of partnership liabilities (50% of the $1,600 liability). The net result of these adjustments is an increase of $800 to G's partnership basis ($1,000 original basis plus ($1,600 liability less $800 G's share of liability) = $1,800). G's basis in the distributed property is $1,800, the lesser of the partnership's basis ($2,000) and G's basis in his partnership interest immediately before the distribution ($1,800). G does not recognize gain as a result of the distribution.

Example 2:
In the previous example, assume that T's basis in his partnership is $600. As a result of the distribution to G, T's share of partnership liabilities is reduced by $800 (50% of the $1,600 liability). The reduction in liabilities is treated as a constructive cash distribution to T, and will produce gain of $200 to T under IRC §731(a) (the extent to which the $800 constructive distribution exceed T's $600 basis in his partnership interest). T's basis in his partnership interest following the distribution is zero.

6585 Loans vs. Distributions

A loan is a distribution of money or property to a partner who is under an obligation to repay or return the distributed amount to the partnership.

A loan is not taxed as a current distribution and will not result in gain recognition to the partner. Instead, a loan is treated as a transaction between the partnership and a partner not acting in the capacity of a partner. [IRC § 707(a); Treas. Reg. §1.731-1(c)(2)]

A payment to a partner is **not** considered a loan unless the partner is under an unconditional and legally enforceable obligation to repay a specific sum at a determinable date. [Rev. Ruling 73-301, 1973-2 CB 215]

- The obligation to repay must be created at the time the funds are disbursed. Bookkeeping entries alone are insufficient to establish the existence of a loan. The fact that the payment creates a deficit in the partner's account which the partner is under an obligation to restore upon liquidation is also not enough to create an obligation to repay a loan.

See Rev. Rul. 57-318, 1957-2 CB 362; Rev. Rul.73-301, 1973-2 CB 215

Note: Rev. Rul. 57-318 and 73-301 create an ambiguity. In the earlier ruling, the IRS implied that an absolute obligation to restore a capital deficit would result in the transaction being treated as a loan. However, the later ruling involved a situation where the obligation to restore the partner's capital account was less binding. This ruling held that his less binding provision did not result in the transaction being treated as a loan. Although the results of the tow rulings are less than clear, it appears that the IRS will treat an absolute obligation to restore a capital account deficit as a loan, while it will not treat a less binding provision to restore a partner's capital account as a loan.

6590 Guaranteed Payments

When a partner performs services for, or advances capital to, his partnership within his capacity as a partner and his payment for such is determined without regard to partnership income, the payments are guaranteed payments. [IRC § 707(c)]

A partnership is considered as an entity separate from the partners whenever a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership. Therefore, when a partner engages in a transaction with the partnership and the transaction is not in his capacity as a partner, the transaction is treated as if it occurred between the partnership and a nonpartner. [IRC § 707(a)]

- Where management services are rendered to a partnership by a partner pursuant to partnership agreement (as opposed to a separate management agreement) and based on the gross income of the partnership, there is some confusion as to how they should be characterized. The Tax Court held that such payments should be classified as a distributive share of partnership income. [Pratt v. Commissioner, 64 T.C. 202 (1975)] The Tax Court's opinion does not appear to be consistent with congressional purpose, and as a consequence, the IRS has ruled that the payments in such situations should be governed by IRC §707(c). [Rev. Ruling 81-300, 1981-2 C.B. 143] However, the legislative history of the Deficit Reduction Act of 1984 sstates that the payments in such situations should be governed under IRC §707(a), and not IRC §707(c). [Senate Comm. On Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, S.Prt. No. 169, at 229, 230]

A guaranteed payment is deductible by the partnership (unless it must be capitalized) and is taxable as ordinary income to the partner. [Treas. Reg. §1.701-1(c)]

Example 1:
C & F Partnership has gross income of $5,000, business expenses of $3,000 and pays $1,000 to partner C. If the payment is a current distribution (rather than as a guaranteed payment), the payment will be treated as a tax-free distribution to C that is not deductible by the partnership. The partnership would have income of $2,000 ($5,000 gross income less $3,000 business expenses), allocable $1,000 to C and $1,000 to F.

If the payment is treated as payment to C in his capacity as a partner as payment for services or as use of capital, it will be treated as a business expense by the partnership and is includible in C's income as compensation for services. In that case, the partnership would have taxable income of $1,000 ($5,000 gross income less $3,000 business expenses less $1,000 guaranteed payment) and both C and F's share of the income is $500.

Example 2:
The partnership agreement of CDE Partnership provides that C is to receive an annual payment of $25,000 for services rendered. The payment qualifies as a guaranteed payment. If the agreement provided that C is to receive 20% of

partnership income, with no minimum guaranteed amount, the payment would not qualify as a guaranteed payment. [Treas. Reg. §1.701-1(c), Example 3]

For a further discussion on guaranteed payments under IRC §§ 707(a) and (c), See McKee, Nelson & Whitmire: Federal Taxation of Partnerships and Partners, Third Edition, ¶ 13.01[1]-[3] or CCH Explanations & Analysis—Federal Tax Service, Chapter H:12.

6595 Character of Gain Recognized

Any gain or loss recognized on a distribution from a partnership is considered to be gain or loss from the sale or exchange of the distributee partner's partnership interest. [Treas. Reg. §1.731-1(a)(3)]

- That gain is capital gain or loss except as otherwise provided in the rules relating to unrealized receivables and inventory. [Treas. Reg. §1.731-1(a)(3) and IRC §741(a)]

If a partnership distributes unrealized receivables or inventory (does not have to be substantially appreciated inventory), the gain realized by the recipient partner upon the subsequent disposition of that property may be treated as ordinary income or loss. [IRC §735(a)] Any gain or loss on the subsequent disposition of unrealized receivables by the distributee partner will result in ordinary income or loss treatment. Any gain or loss realized by a partner from the sale or exchange of distributed inventory that was sold by him **within five years** from the date of distribution will also be treated as ordinary income or loss. [IRC §735(a)]

- After the five-year time period has elapsed, the character of the distributed property is based on its character in the hands of the distributee at the time of the sale. [Treas. Reg. § 1.735-1(a)(2)]

If a partner receives only a reduction of partnership liabilities upon his withdrawal from the partnership, the reduction is deemed to be a cash distribution to the partner from the partnership. Accordingly, the partner is treated as receiving a distribution in exchange for his partnership interest, causing the transaction to be treated as a distribution that results in capital gain or loss. [Stilwell, Andrew, (1966) 46 TC 247]

Example:
J receives a distribution of partnership inventory in liquidation of his partnership interest. The inventory after distribution assumes J' basis in his partnership interest which is $50,000. IRC §732(c) limits the adjusted basis of the distributed inventory in the hands of the partner to the pre-distribution basis that the partnership had in such property, provided that IRC §§734 and 751(b) doe not

come into play. Within 5 years of the distribution, J sells the inventory to a dealer for $80,000. The $30,000 gain will be taxed as ordinary income. If J had waited to sell the property until after the required five years, he would treat the gain as capital gain if he is not a dealer at the time of disposition.

6600 DISTRIBUTION TO RETIRING PARTNER

6610 General

The characterization of payments from a partnership to a withdrawing partner is significant because it determines:

- whether the withdrawing partner recognizes capital gain or loss or ordinary income with respect to the payments;
- the timing of the gain, loss or income recognition by the withdrawing partner;
- whether the partnership is entitled to a deduction with respect to the payments; and
- whether the remaining partners are entitled to an exclusion from their own share of partnership income with respect to the payments.

The general rules of IRC §731 regarding the recognition of gain or loss on partnership distributions may not apply if payments are made to a retiring partner or a deceased partner's successor in interest. [IRC § 731(c)&(d)] In those instances, IRC §736 is applicable.

IRC §736 attempts to allocate amounts received by withdrawing partners either as income payments (referred to as §736(a) payments) or as payments for property (referred to as §736(b) payments).

IRC §736 generally classifies payments from a partnership to a withdrawing partner into one of three categories. Payments in liquidation of his partnership interest may be classified as:

- payments in consideration for the withdrawing partner's interest in partnership assets; [IRC § 736(b)]
- a distributive share of partnership income; [IRC § 736(a)(1)] or
- a guaranteed payment. [IRC § 736(a)(2)}

Under §752(b), a partner is treated as receiving a distribution of money to the extent of any reduction in his share of partnership liabilities. Therefore, in addition to actual distributions of money and property, the § 736 distributions to a retired partner include any deemed distributions to him under § 752(b). [Treas. Reg. § 1.736-1(a)(2)]

§736(a) payments are payments made to a retiring partner or to a deceased partner's successor in interest that are **not** in exchange for his interest in partnership property. They are either treated as a distributive share of partnership income [IRC § 736(a)(1)] or as a guaranteed payment. [IRC § 736(a)(2)]

- If the payments are determined with regard to the partnership's income, they are treated as a distributive share of partnership income. [Treas. Reg. § 1.736-1(a)(4)]
- If the payments are made without regard to partnership income, they are treated as guaranteed payments. [IRC § 707(c)] They are taxed as ordinary income to the partners and deductible by the partnership.

Payments treated as a distributive share of partnership income or guaranteed payments reduce the remaining partners' taxable share of partnership income either because the payments to the retiring partner reduce the distributive share of the partnership income which would otherwise be taxable to the remaining partners, or because the payments are treated as guaranteed payments that are deductible by the partnership.[Treas. Reg. § 1.736-1(a)(4)]

Generally, §736(b) payments include all payments for a retired partner's interest in partnership property. There are two exceptions to what constitutes partnership "property" for §736(b) purposes.

1. §736(b) property does not include cash-method accounts receivable and other rights to payment for goods and services (to the extent not previously included in income) described in §751(c). [IRC § 736(b)(2)(A)]

2. Payments for a retired general partner's share of the goodwill of a partnership in which capital is not a material income-producing factor are not treated as paid for §736(b) property unless the partnership agreement provides for a payment for goodwill. [IRC § 736(b)(2)(B)]

The term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership. [IRC § 761(d)]

- This includes a series of distributions whether they are made in one year or in more than one year as long as the partner's entire interest is ultimately to be terminated. [Treas. Reg. § 1.761-1(d)]

Partnership distributions in partial liquidation of a partner's interest are potentially subject to IRC §707(a)(2)(B), 704(c)(2), 731, 737, or 751(b) (See PTM 6110) rather than IRC §736, which deals with a complete liquidation of a partner's interest. [Treas. Reg. § 1.761-1(d)]

The partnership cannot deduct §736(b) payments made to a withdrawing partner.

Generally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct. [Treas. Reg. § 1.736-1(b)(1); see Elwood R. Milliken, 72 TC 256 (1979), aff'd unpub. opinion (1st Circuit 1980)]

6620 Definition of a Retiring Partner

Payments made in liquidation of the interest of a withdrawing partner refers to all liquidating distributions from a partnership, which are attributable to a partner's withdrawal, regardless of the reason.

A partner may not be considered a partner under local law, but nevertheless will be treated as a partner for purposes of subchapter K until his interest in the partnership is completely liquidated. [Treas. Reg. § 1.736-1(b)(1); see Elwood R. Milliken, 72 TC 256 (1979), aff'd unpub. opinion (1st Circuit 1980)]

A partner who retires from a partnership for state law purposes is still considered to be a partner for income tax purposes if he is entitled to receive any distributions from the partnership after the date of retirement. [Treas. Reg. § 1.736-1(a)(1)(ii)] However, a series of payments that will ultimately result in the liquidation of a partner's entire interest in the partnership will be considered as payments in retirement of the partner's interest and will be characterized under IRC §736, rather other sections of the Internal Revenue Code. [Treas. Reg. § 1.731-1(c)(1)(i), § 1.761-1(d)]

6630 Timing of Recognition of Income

A retiring partner's interest in partnership §736(b) property may be liquidated through a series of payments spanning several years.

The timing of the recognition of gain or loss with respect to such payments is determined under §731, [Treas. Reg. § 1.736-1(b)(6)] which generally defers the reporting of gain until the distributee's entire basis has been recovered [Treas.

Reg. § 1.731-1(a)(1)] and defers the recognition of loss at least until all distributions have been made. [IRC § 731(a)(2)]

There are two exceptions to this rule.

1. Payments which are subject to IRC §751(b). In this case, the retired partner's interest in the §751 property is treated as distributed to him and then sold back to the partnership. Therefore, the gain or loss attributable to these payments is reported as a gain or loss on the sale or exchange of property.
2. If the total amount of the §736(b) payment is fixed, a retired partner may elect to apportion a part of the total gain or loss among the installment payments by allocating a portion of the basis to the total amount payable under §736(b). The election must be made on the retiring partner's tax return for the first taxable year in which he receives a §736(b) payment. [Treas. Reg. § 1.736-1(b)(6)]

Thus, the general rule is that §736(b) payments are reported according to a cash-basis, cost-recovery method of accounting, regardless of the method of accounting of the partnership or of the partner receiving the payments. (See Example)

Example:
A retired partner is to receive $500 in five annual installments of $100 each in liquidation of his interest in §736(b) property, none of which is §751 property. The partner's basis in his partnership interest is $200. Under the general cost-recovery rule, the retired partner would recover his entire basis after the second $100 installment, and the remaining three installments would constitute taxable gain in their entirety. If, on the other hand, he elected to apportion the gain among the installments, $40 of each liquidating installment would be treated as basis recovery, computed as follows: $200 the adjusted basis in his partnership interest divided by the number of payments i.e. five. The $60 balance of each installment would be taxable gain, computed as follows: $100 (the amount of each installment) less $40 allocable portion to his basis.

6700 HOLDING PERIOD OF DISTRIBUTED ASSETS

Generally, a distributee-partner is allowed to include the partnership's holding period in computing his holding period for property received in a distribution from a partnership. [IRC § 735(b)] This rule applies whether the property is received in a current distribution (See PTM 6110) or a liquidating distribution (See PTM 6210).

If the partnership acquired the distributed property by contribution from a partner, the distributee is entitled to include the period the property was held by the contributing partner under IRC §1223. [Treas. Reg. § 1.735-1(b)]

Tacking on the partnership's holding period is not allowed with respect to partnership property that a partner is viewed as acquiring by purchase rather than in a distribution. [Edwin E. McCauslen, 45 TC 588 (1966); Revenue Ruling 67-65, 1967]

If a partner receives inventory as part of a distribution, the five-year period during which distributed inventory items have an ordinary income taint starts with the date of the distribution, and no credit is given for the partnership's holding period for the distributed property. [Treas. Reg. § 1.735-1(b)]

6800 CASE LAW

6810 Holding Period

One partner in a two-person partnership purchased the partnership interest of his deceased partner, thereby terminating the partnership. The Tax Court refused to permit the purchaser to tack the partnership's holding period under §735(b) with respect to the one-half interest in partnership property attributable to his deceased partner, reasoning that because the purchase of the interest and the termination of the partnership occurred simultaneously, the purchasing partner should be viewed as having acquired one half of the partnership's assets by purchase rather than by distribution.
Edwin E. McCauslen, 45 TC 588 (1966)

Cora-Texas involves a liquidating distribution of preferred stock from a partnership to the partner who was the issuer of the preferred stock. The distributee-partner argued that it should not be prevented from recognizing a loss on the liquidation of its partnership interest under the pre-1954 equivalent of §731(a)(2), pointing out that because the preferred stock it received in the distribution was canceled, it would not have any subsequent opportunity to realize the loss. Although indicating agreement with the taxpayer's argument that a partner who receives shares of its own stock as part of a liquidating distribution should not be prevented from recognizing a loss by reason of such receipt, the district court found that no loss had actually occurred in the transaction at hand.
Cora-Texas Manufacturing Co. v. United States, 222 F. Supp. 527 (ED La. 1963), aff'd per curiam, 341 F2d 579 (5th Cir. 1965)

6820 Guaranteed Payments

Regardless of whether the payment is properly classified as a "guaranteed payment", a partnership can only deduct payments made to a partner for services if they represent deductible expenses of the partnership.
Cagle, Jackson Jr., (1974) 63 TC 86, affd on other issue(1976, CA5) 38 AFTR 2d 76-5834, 539 F2d 409, 76-2 USTC

A management fee of 5% of gross rental income paid to a general partner in a partnership engaged in real estate development was held to be unrelated to the partnership income and therefore, a guaranteed payment. Although the Tax

Court held that "income" included "gross income for purposes of IRC §707(c), the IRS interpreted the term "income" for purposes of the statute to mean the "taxable income" of the partnership. Cf. *Pratt v. Commissioner, 64 T.C. 202, (1975) with* Revenue Ruling 80-300

6830 Payments to Retiring Partner

The taxpayer withdrew from a two-person partnership and received nothing for his partnership interest in connection with the withdrawal. The other partner agreed to pay all debts of the partnership and further agreed to indemnify the taxpayer in connection with any partnership indebtedness. The taxpayer argued that he was entitled to an ordinary loss in connection with the withdrawal measured by his basis in his partnership interest. The Tax Court disagreed and held that the loss was capital in nature, reasoning that the taxpayer received a deemed distribution of cash pursuant to IRC §752 due to the relief from partnership indebtedness. The deemed payment was subject to IRC §736 and, pursuant to IRC §§736(b) and 731, the loss resulting from the withdrawal was capital in nature. Thus, the Tax Court held that relief of a partner's share of liabilities with no distribution of either cash or property constitutes a §736 payment.
Stilwell v. Comr., T.C. 247 (1966)

A partner withdrew from an engineering partnership and there was no withdrawal agreement was signed because of a dispute regarding the valuation of the partner's interest. However, the withdrawing partner received payments from the partnership (based on a valuation of his interest by the partnership's accounting firm) and was relieved of his share of the partnership's liabilities. The court held that the cash distributions and the relief of liabilities were taxable to the withdrawing partner to the extent the payments were treated as being for the partnership's unrealized receivables. The partner argued that the payments were not fixed payments since (1) there was no specific time when the payment had to be made, and (2) the total amount to be received was not fixed since it was possible that he would receive additional payments because of his dispute with the remaining partners over the valuation of his partnership interest. The Tax Court affirmed by the Sixth Circuit, held that the regulations do not require that the time of the payments be fixed and that the amount that he was entitled to receive based on the accountant's valuation be a fixed amount. The Tax Court also rejected the taxpayer's argument that he was not a retiring partner because he remained a partner under state law until his state court action was resolved, holding that under state law he was not a partner, but only had a right to receive payments. Accordingly, the amount distributed was treated under prior law as a guaranteed payment to the extent of the portion attributable to the unrealized

receivables and the remainder was treated as a return of the withdrawing partner's basis and capital gain to the extent of any excess over his basis.
Quirk, Thomas P. Est, (1988) TC Memo 1988-286,(affirmed) 67 AFTR 2d 91-782, 928 F2d 751, 91-1 USTC

6840 Gain or loss on Partner Liquidation
In spite of the dissolution of the operation of a partnership during the tax year, a partner was not relieved of partnership liability since he continued to be liable on his personal guarantee of a bank's participation loan. Therefore, he did not realize short-term capital gain when he forfeited his interest to the partnership. The taxpayer remained liable on his personal guarantee of the partnership loan since there was no agreement between the taxpayer and the remaining partners relieving him of liability. Also, the bank did not expressly release the taxpayer from his personal guarantee.
R.B. Weiss, CA-11, 92-1 USTC ¶50,168 , 956 F2d 242